NATIONAL TAX JOURNAL

Volume III, No. 1 **March 1950**

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PUBLISHED QUARTERLY BY THE NATIONAL TAX ASSOCIATION

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PUBLISHED QUARTERLY BY THE NATIONAL TAX ASSOCIATION

Yearly subscription, $3.75
(To members included in
annual dues)

Single copy, $1.25

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Communications for the editor, manuscripts, and books for review should be sent to Roy Blough, Editor, National Tax Journal, 1126 East 59th Street, Chicago 37, Illinois.

Opinions expressed in the JOURNAL are not to be construed as those of the National Tax Association unless expressly so stated.

Entered as second-class matter April 29, 1948, at the post office at Lancaster, Pennsylvania, under the Act of March 3, 1879.

National Tax Journal

Volume III, No. 1 March 1950

STATE-MUNICIPAL FISCAL RELATIONS: A CRITICAL COMMENTARY*

MORTON GRODZINS †

THE LATE Henry Simons left as part of his intellectual legacy a remarkable " political credo " which says, in part:

Modern democracy rests upon free, responsible local government and will never be stronger than this foundation. . . . A people wisely conserving its liberties will seek ever to enlarge the range and degree of local freedom and responsibility. In so doing, it may sacrifice possible proximate achievements. Doing specific good things by centralization will always be alluring. It may always seem easier to impose " progress " on localities than to wait for them to effect it themselves. . . . Progress to which local freedom, responsibility, and experimentation have pointed the way may be accelerated for a time and effected more uniformly by the short cut of central action. But such short-cutting tends to impair or to use up the roots of progress in order to obtain a briefly luxuriant bloom.[1]

This is a statement of political values to which municipal and state officials, and their professional associations, almost unanimously give support. The position is taken not only by the state governors in their relationships with the national administration and not only by municipal officers in their negotiations with state offices. It is also expressed, at least verbally and frequently in concrete measures, by state officials and state legislators in dealing with municipal officers and municipal affairs.

The history of state-local relations in the United States during the past several years is characterized by an attempt to formulate a specific program for the

* I have had the advice and criticism of Carl Chatters and Winfield Best, both of the American Municipal Association; Frank Bane and Frank Smothers, both of the Council of State Governments; Charles Conlon and Ray Garrison, both of the Federation of Tax Administrators; and I. M. Labovitz and Bernard Larner, both of the U. S. Bureau of the Budget. The responsibility for what is said is entirely my own.

† The author is assistant professor of political science at the University of Chicago.

[1] Henry C. Simons, *Economic Policy for a Free Society* (Chicago: University of Chicago Press, 1948), p. 13. For a parallel statement by John Stuart Mill, see *On Liberty* (Everyman's Library Edition; New York: E. P. Dutton and Co., 1910), pp. 168-69.

achievement of "free, responsible local government." This program has been largely expressed by the states in the granting of new tax powers to municipalities and by municipalities in the levying, for the first time, of a wide variety of non-property taxes.

The purpose of the following paragraphs is to assess this development in terms of the value of "free, responsible local government."

Growth of Local Non-Property Taxes

The growth of local non-property taxes is a phenomenon of current public financing. It is the outstanding single trend in the development of state-local relations. Localities now tax everything from cats to personal incomes, from bicycles to public utilities, from amusement devices to business receipts. In some states localities still do not utilize non-property taxes to any appreciable extent, and property taxes still remain by far the most important source of municipal revenue. Nevertheless, non-property taxes are rapidly increasing in number and rapidly becoming more important in the tax collections of American cities.

In 1947, the nation's 397 largest cities (those over 25,000 population) collected non-property tax revenues of $441 million as compared with $1,866 million from property taxes and $607 million from state-aid. But whereas property tax yields increased 5.9 per cent between 1946 and 1947, non-property taxes increased by more than 46 per cent. Municipal sales and gross receipts taxes increased by 78.7 per cent.[2] Preliminary data for 1948 show a continuation of the same trend. Non-property taxes for the 397 largest cities increased by 27.8 per cent; property taxes increased by 10.2 per cent.[3]

An even more striking comparison is that of fiscal years 1942 and 1948. Between these years, property tax revenues increased 22 per cent; non-property tax revenues 134 per cent. Sales and gross receipts taxes increased 184 per cent.[4]

The expansion of non-property taxes has been most pronounced among the nation's largest cities. But smaller municipalities have also contributed to the trend. Property tax collections of all cities increased by 22 per cent between 1945 and 1948; non-property taxes increased by 119 per cent.[5]

The increase in the number of local non-property taxes has been most notable since 1944. The trend has been accelerated during the past few years by new state laws.

Pennsylvania's 1947 law is, of course, the prime example. It gave virtually unlimited taxing powers to the State's municipalities and other local governments. Under that law, more than seven hundred localities adopted more than a thousand new levies,[6] including

[2] U. S. Bureau of the Census, *Compendium of City Finances in 1947* (City Finances: 1947, No. 2) (Washington, D. C.: Government Printing Office, October, 1949), pp. 2, 4.

[3] U. S. Bureau of the Census, *Summary of City Government Finances in 1948* (Washington, D. C.: Government Printing Office, October, 1949), p. 4.

[4] *Ibid.*, p. 4.

[5] U. S. Bureau of the Census, *Government Revenue in 1948* (Washington, D. C.: Government Printing Office, 1949), p. 7. "All cities" are defined as incorporated places with powers of general government and include villages, boroughs, and—except in New England, New York, and Wisconsin—towns.

[6] *Taxes Levied Under Act 481* (Supplement, February 1, 1949, to November 15, 1949) (Department of Internal Affairs, Commonwealth of Pennsylvania, 1949), p. 2.

taxes on personal incomes, admissions, pinball machines, and other mechanical games; and mercantile, business, severance, and per capita taxes. Though 1949 amendments limited the scope of the 1947 law, Pennsylvania's local governments still enjoy exceedingly wide taxing powers.[7]

Pennsylvania does not stand alone in the field. The New York legislature has recently given municipalities authority to levy an extensive range of specific taxes. West Virginia has extended wide taxing power to its cities. Maryland has similarly opened new tax pastures to Baltimore, and Minnesota has authorized the city of Minneapolis to levy a salary withholding tax. Cities of Kentucky, under a recent law, have the power to collect a wide range of excise taxes. Connecticut, California, New Jersey, Illinois, and Rhode Island have recently given localities permission to levy sales taxes. More than 100 cities in California alone levy such taxes, all imposed since 1945. At least 86 local governments in 4 states, including several below 25,000 in population, now collect an income tax.

A survey by the International City Managers' Association has revealed for cities over 10,000 population that:

At least 194 of these cities levy taxes on some or all public utilities; 16 of these cities levied the tax for the first time in 1948.

At least 163 of these cities levied taxes on the gross receipts of business concerns; 10 adopted these taxes for the first time during 1948.

At least 148 of these cities taxed admissions to theaters and other amusements; 34 adopted the tax first in 1948.

At least 50 of these cities taxed retail sales of merchandise; 12 first adopted the tax during 1948.

At least 22 of these cities taxed incomes of individuals and earnings of businesses; 10 adopted the tax in 1948.

At least 37 of these cities levied a cigarette or tobacco tax; 7 of these taxes were new adoptions.[8]

All this adds up to an impressive indication of a trend in the direction of expanding local tax powers. Actual large-scale adoptions of non-property taxes have so far been confined to relatively few states, and some evidence of a counter-trend exists: Wisconsin, for example, has prohibited municipalities from levying an income tax; and Kentucky, Illinois, and Ohio have recently taken steps to strengthen property tax administration, at least partially as an alternative to the utilization of non-property taxes. But these counter-influences are not impressive. They are far overbalanced by the data given above, and by the near-unanimity that exists among both state and local officials with respect to the necessity and desirability of expanding local non-property taxes.

The New Taxes Supported

The plight of most city governments is not a happy one. They have been faced during the past several years with a steadily rising price index and with

[7] For discussion of 1947 law and 1949 amendments, see Richard C. Spaulding, "Pennsylvania Amends Permissive Local Tax Law," *National Tax Journal*, II (1949), 272-77.

[8] Frederick C. Peitzsch, "Municipal Non-Property Taxes," *Municipal Year Book, 1949* (Chicago: International City Managers' Association, 1949), pp. 193-98. There are 1,072 cities of over 10,000 population; 85 per cent of these replied to the questionnaire sent them by the International City Managers' Association.

consequent rapidly rising costs for commodities and personnel. They have been faced with insistent demands for new and expanded public services. They have been faced with the bleak necessity of war-delayed plant expansion and plant maintenance. They are probably soon to be faced with increased welfare costs as the war and postwar boom runs its course.

These are new manifestations of old complaints, aggravated by inflationary conditions. The response of city officials has been the widespread demand for new tax powers. These demands have been coupled with a drive for general municipal home rule and have been made in the following terms:

The people of an incorporated city should have the right to handle their own affairs under a constitutional grant of power from the state. . . . They should have authority to raise revenues from any local sources without being required to beg for funds to pay for the services they need. . . .

Local government in the United States should be autonomous so far as is practical and consistent with public welfare. . . . While no municipality can have complete autonomy, the cities should have the maximum local authority consistent with their position as constituent elements in a sovereign state. . . .

Municipal governments are entitled to sufficient revenue to finance the activities required of them by custom or by law. Where the local citizens demand a local service they must expect to pay for it. . . .

Unless the state provides adequate revenue by other measures, municipalities which can administer them should be authorized to use as local taxes the payroll-income tax, local sales taxes, license taxes based on volume of business, cigarette and tobacco taxes, amusement or admissions taxes, hotel taxes, liquor taxes, utility taxes, and various service charges.[9]

From the point of view of the states, there are also good reasons for increasing municipal freedoms, especially in the field of taxation. They have been expressed by the state governors (who face grave fiscal problems, themselves) as follows:

1. Just as it is essential that overcentralization be prevented in Washington, so it is necessary that overcentralization be prevented within the states. When local activities are paid for out of state-collected funds, state control of local affairs is likely to follow.

2. If localities become dependent upon the state governments for funds, the localities will be likely to turn to the states for the solution of essentially local problems. This decreases citizen interest in problems of local government. The way to maximize citizen participation in local affairs is to make localities, to every extent possible, fiscally responsible for their own activities. This citizen participation in local government is fundamental to the strength of the national state.

3. Furthermore, extensive state-aid programs encourage both wastefulness and extravagance. If local governments, themselves, raise the money they spend, those governments will call for fewer services and administer their affairs more economically.

4. By giving localities control over their own affairs, local officials and local citizens will understand the difficulties of apportioning limited funds. They will become conscious of the pressure groups which legislators find difficult to oppose.[10]

[9] *National Municipal Policy for 1949* (Chicago: American Municipal Association), pp. 2-3.

[10] Summarized from discussions at the 1948 and 1949 Governors' Conferences. See *State Government*, August, 1948, pp. 171-74; August, 1949, pp. 202-03.

The state governors have matched their words with deeds. One measure of this is the laws increasing local tax powers. Another indication is a resolution of the 1948 Governors' Conference which favored "the extension of local powers of taxation in order to strengthen local government and its capacity to meet the needs of its people and to discourage the present trend toward centralization of government in the states." [11] And the 1949 program of suggested state legislation developed by the Council of State Governments and circulated to all states includes a model "Municipal Tax Levying Enabling Act." This law, largely modeled on Pennsylvania's 1947 statute, "would give local governments wide discretion in the field of taxation. Home rule from a fiscal standpoint would become a reality." [12]

Tone of the Argument

The arguments advanced by both state and local officials in support of enlarged municipal taxing powers reflect a strongly separatist attitude and express a concern for status and for personal and institutional prerogative. The quotations above indicate this. But there are even more revealing statements. For example, an official policy statement of the leading organization of municipalities says: "Municipalities should not be required to support state projects, pay for state services, or carry financial burdens imposed on them by the state." [13] And the forty-eight state governors reach agreement on the proposition that "the 'pleasure' of spending public monies [by localities] must be linked with the 'pain' of levying and collecting taxes." [14]

Every large-scale organization develops within itself informal social groups whose attitudes and purposes conflict with other similar groups and may, indeed, run contrary to the larger objectives of the organization they presumably serve. The hostilities engendered may be expressed in internal organizational schisms or may be channeled outward against other agencies, as in the interagency battles of the New Deal. One of the unique attributes of federalism—and of the hybrid federalism of states and localities—is that it establishes natural lines on which the battle of social organizations can be formed. It tends to subordinate intralevel clashes to interlevel ones. The particular aims, and methods of achieving them, of one level of government seem the natural and the best way to those working in that government. Where the aims and methods of governments differ, workers at each level tend to believe that only they are right and that their counterparts in the other government are wrong. This psychological phenomenon duplicates, in a minor scale, the tune played *fortissimo* on the international scene.

A countertendency to this familiar pattern of in-group hostility towards the out-group is found within American

[11] *State Government*, August, 1948, p. 174.

[12] Interpretive statement, attached to "Municipal Tax Levying Enabling Act," *Suggested State Legislation, Program for 1949* (Chicago: Council of State Governments, 1948), pp. 25-30.

[13] *National Municipal Policy for 1949*, American Municipal Association.

[14] *State Government*, August, 1948, p. 161.

interlevel government. This is the tendency of professional workers at each level of the government to identify themselves with the function to be performed, rather than with the particular government served. Here one may find cohesive groups among professional workers in public health, welfare, education, and other fields. Their own standards of professional conduct, their interest in the job to be performed, and the pressures exerted by their clients produce a guild-like loyalty that transcends their identification with that government which happens to pay their salary.[15] This type of identification is strong in some fields and in some areas. But it never completely effaces the worker's identification with his own unit of government. In some cases, ambivalent and conflicting loyalties may be held.

Even when the functional loyalties of professional workers are strong, the chief political officers of both municipalities and states maintain their separatist attitudes and a certain degree of competitiveness and combativeness in their relationships with each other. Social cohesiveness along lines laid down by the unit of government is still dominant among those who determine basic policies, including tax policies.

The process of separation and of regarding government as an end, rather than as a means, is aided by a second factor. If one asks *why* citizens take no great interest in state and local governments, the answer is easy. In the American culture, for most people in most places, business and job activities are the center of a man's time and attention. (Our culture asks for success, and business success is both highly valued and conspicuous.) After a man's business comes his family. After his family come the great voluntary associations and leisure-time activities (the Rotary, the golf club, the card table) or the activities dictated by social position and conscience (the labor union, the church, the Community Chest). After these, if time and energy are left, may come an interest in matters of government. But here one's first attention is usually directed to national and international affairs, which are always spectacular and always writ large on the front page of the daily newspaper. Relatively few men, therefore, are concerned with the affairs of state and local government.

This pattern of life, incidentally gives a solid sociological base for Senator Plunkitt's contempt for "reformers" ("mornin' glories—lovely in the mornin' and withered up in a short time"); and it accounts for the professional politician's insistence upon the necessity of concrete rewards to keep the organization rolling. The life-pattern also explains why women—and women's groups—sometimes seem to be the only active civic force in local and state affairs. Most women are freed from the continuous business preoccupation of their men; they are freed from the continuous childbearing that characterized previous generations; and their social groups are not usually involved in such unworldly and time-consuming activities that constitute the thirty-three *rites du passage* of a Mason.

The point of this excursion for the present discussion is a simple one: the

[15] See statement of Professor William Anderson, *Joint Hearings before the Subcommittees on Intergovernmental Relations of the Committees on Expenditures in the Executive Department* (Washington: Government Printing Office, 1949), p. 124.

very lack of civic interest in state and local government makes it all the easier for an official of a state or municipality to fight his battles as if his government were a vested interest, with prerogatives and values apart from the services it renders to its residents and to the larger national community.

The absence of civic watchfulness, plus the social cohesiveness produced within governments in their relationships with other governments, account for the type of arguments made by both state and municipal officials in justifying the expansion of municipal non-property taxes. These factors induce both sets of officials to overlook the fact that their respective governments serve the same people in a common cause.

The Power Issue

But it is clear that these social-psychological considerations are only permissive. They allow the battle to be waged; they only partially explain why it is being fought.

The movement for increasing the taxing powers of municipalities can be understood only as one phase of a larger and more fundamental power controversy. This is the familiar controversy over " centralization ": just as municipal officials believe they suffer loss of freedom as the result of state fiscal policies and state legislative and administrative practices, so the state official reacts to Federal programs.

The laments expressed cannot be regarded simply as the crocodile tears of political conservatives or as the natural attempts of men to arrogate power to themselves and their positions. These factors are undoubtedly present. But there also exists a sincerely expressed fear of over-centralized government and a conviction that the strength of the national democracy rests on the strength of government at the local (and state) level. Furthermore, the complaints about over-centralization result from genuine embarrassments: from policies of higher government impeding the discretion and resources of the lower one.

From this perspective, the enlargement of local taxing powers becomes only one phase of the larger struggle over the allocation of political power in the American federal system. It cannot be doubted, for example, that the state governors' willingness to grant new taxing authority to municipalities is closely connected with the governors' own efforts to effect a division of tax resources with the Federal Government. Nor can it be doubted that the willingness of certain taxpayers' groups to support enlarged local taxes rests upon a belief that, in the long run, these taxes are more amenable to group pressures than the taxes of the national government.

The issues in the whole controversy are clouded because of the ambiguity of such phrases as " free and responsible " or " strong and vital " municipalities. Everybody can readily agree on the importance of " strong " and " vital " cities. But what do the adjectives mean? If they mean the functional activities of cities, then cities are stronger and more vital than ever before in their history: despite the cries of " centralization " they are spending more money, doing more things (and probably more efficiently), and touching the lives of citizens more frequently than ever before in the past. On the other hand, if the desirable attributes of municipal government mean independence of action,

then there can be no doubt that cities are less strong and less free than at some periods in the past.

In the latter sense of these words, the cities (and states) are sharing in a fundamental social trend which has affected all institutions. The simultaneous increases in population, in technical effectiveness, in the division of labor, and in the contacts between individuals, groups, and nations have produced an interdependence within the social structure which has, inevitably, decreased the scope of absolute freedoms. When the consequences of free activity may result in dangers to the whole society, then freedoms must be limited. This is true for the constitutional freedom of individual American citizens. It is no less true for social institutions. The controls exercised over businesses, labor unions, and lobbying groups are a case in point. The decline in the unfettered discretion of cities and states is a related case. If municipal freedoms result in tax policies that are inimical to the national economy or in public health programs that endanger the lives of whole population groups, then it is quite clear that those freedoms should not be exercised.

The grant-in-aid technique by which municipal (and state) functions are stimulated and municipal (and state) freedoms are sometimes simultaneously curtailed is, at present, the favorite whipping boy of those opposed to " centralization." But the grant-in-aid, obviously, is a symptom, not a cause. It symbolizes government's reaction to the interdependence of governmental activity. It is also a device for meeting the demands of that interdependence while retaining flexibility of administration and that degree of local (and state) discretion not inconsistent with the larger national need.

All this does not mean that the demands for greater municipal and state powers are without merit. It does not mean that some reallocation of functions between the levels of government in the federal system should not take place. It does not mean that steps cannot be taken to strengthen the fiscal position of states and localities. It does mean that municipal freedom, responsibility, vigor, and strength cannot be measured in parochial terms; and it does mean that the full meaning of these alluring adjectives must be fully understood before intelligible policy can be established.

The issue of how much local freedom still remains. It cannot be resolved in absolute definitions or in platitudinous appeals to the past. Local freedoms, in the sense of local discretion to meet local problems, are of course important; they are important in terms of administrative efficiency and in terms of encouraging participation of citizens in the affairs of government. (Citizen disinterest and boss rule are not cured by depriving cities of their functional role.) But this desirability must be equilibrated with a realistic view of modern governments operating in a tightly geared economy and a highly interdependent culture. To ignore these factors in a discussion of local powers and the trend to " centralization " is to miss the only relevant context for such a discussion.

Many Governments, One Job

Governments are means, not ends, and exist in the United States to fulfill the people's goals. Democratic governments properly serve no other purpose.

Neither a state nor a municipality has a vested interest in a revenue to be collected or a function to be performed. Their larger goals are identical. And their functions are bound together.

States and localities and the national government share functions. There is virtually no field (not even foreign affairs) that is the exclusive province of the national government. There is virtually no field (not even schools) that is the exclusive province of the states and localities together. There is virtually no field (not even traffic control for localities, not even highway construction for the states) for which states and localities do not in fact share responsibility.

The freedom of municipalities is therefore only a relative matter. Local governments cannot disengage themselves from the larger state and Federal mechanisms. They cannot be " freed " from constitutional obligations or from the numerous legislative demands that make it necessary for them to provide educational facilities, public protection, health services, judicial processes, and a multitude of additional services. Even if they could be freed from these responsibilities, they should not be. To do so would be to destroy a historic pattern of governmental operations, to dissipate a tradition of cooperative services, and to revert to an untenable feudalism.

Municipal Non-Property Taxes from a Wider Perspective

The expansion of local non-property taxes must be assessed from the perspective of the interdependent culture, of shared responsibilities, and of common purpose. The following disadvantages of most of these taxes then become of preponderant importance:

1. Most of the locally collected non-property taxes bear hardest on those least able to pay. This is true of the gross receipts taxes, the numerous general and specific sales taxes, many of the general business licenses, and the type of flat (i.e., non-progressive) income tax levied by Philadelphia and most other cities using the income tax.

2. Most local taxes are harder to enforce and easier to evade than taxes levied by larger jurisdictions. Enforcement can seldom be adequate in small jurisdictions.[16] The honest tax payer is penalized for his very honesty.

3. Though no data are yet available, it seems certain that the proportion of administrative expenses to taxes collected must inevitably increase as one multiplies the number of taxing units for any given tax. Further, it becomes progressively more difficult to bring about effective cooperative activities in tax administration as the number of taxing bodies, and the number of taxes, increase.

4. There is a further expense to the taxpayer. His cost of compliance increases directly as the number of taxes and tax jurisdictions increases. This is especially burdensome for businessmen operating in several localities; it is a burden much reduced when a given tax is levied by the larger jurisdiction.

[16] It has been estimated that the sales taxes collected by California cities "are only about 70 per cent as effective in raising revenues as would be state taxes imposed at the same rates in the same areas." See Dixwell L. Pierce, "Why State and Local Sales Taxes Should Be Coordinated," *Revenue Administration, 1948* (Chicago: National Association of Tax Administrators, 1948), p. 21. For a number of reasons local tax administration in California is probably a great deal more efficient than it is in most states.

5. Local taxes tend to have undesirable economic effects, as in the movement of businesses and residents from high- to low-tax areas.

6. Dependence on local taxes makes for tax inequities. A severance or business tax levied by a municipality may unduly burden a small segment of the population. On the other hand, it may act as a windfall for other taxpayers, relieving them of even minimum responsibilities for supporting local services.

7. The multiplication of local taxes makes it more difficult to keep the nation's public finance system sensitive to changes in the business cycle. Local revenues dip sharply during depression, and local borrowing capacities are not sufficient to fill either revenue gaps or to meet extraordinary depression expenditures.

Local fiscal systems, as a whole, lack the flexibility needed to offset fluctuations in consumption and investment. Yet the new trend in municipal finance has the purpose, and the effect, of throwing cities upon their own resources. This autonomy, if maintained, can lead in depression only to undesirable results: the transfer of functional activities to other governments, the decrease in municipal services, or the increase in municipal tax rates. The first consequence is discussed below; the other two have undesirable effects in terms of countercyclical financing. To the extent that cities strive to become fiscally self-sufficient, the possibility of achieving successful compensatory fiscal policies is decreased. Those policies can be achieved at the local level only through aids from other governments.

An individual city official may solace himself with the thought that his taxes and expenditures are of monumental insignificance in the total economy. But in the aggregate, local tax systems loom large. Their impact on the national economy it great.[17]

8. All of this has a very real importance in terms of larger local freedoms. During depression, the revenues of localities inevitably fall when the expenditures of cities must inevitably increase. And the new non-property taxes will decline in yield faster than property taxes. Dependence on the new taxes thus threatens the functional role of cities in the American federal system.

This threat is especially menacing because of the added factor that the expansion of municipal non-property taxes is accompanied by a decline in state-aid programs. A system of revenue raising which provides a continuous mechanism for the transfer of funds from states to localities (and from the national government to the states) supplies a ready means for states to bolster local finances during a depression period. With this administrative readiness, localities can normally expect to continue their responsibilities in providing services financed with state and Federal aid. This administrative readiness is periled by the new emphasis on local non-property taxes. Without it, there is a far greater likelihood that municipal services must be curtailed or that the larger unit (either the state or the Federal government) will step in and assume wholesale the functional responsibilities

[17] For evidence of perversity of municipal *and state* fiscal policies, see Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy* (New York: W. W. Norton and Co., 1944), chap. 4.

of impoverished cities. Thus, "freeing" municipalities to dependence on their own resources may lead during depression to their ultimate collapse, fiscally and functionally.[18]

The Alternatives: Nonfiscal Measures

Municipalities should have funds to meet their ever growing functional loads and must have freedom to meet local problems promptly and efficiently. At the same time, they should be able to assume their cooperative role in the joint governmental enterprise. The issue is how these ends can best be obtained.

The drive to diversify the local tax base is frequently supported on the grounds that no other way is immediately available for providing municipalities with desperately needed income. Whatever the merits of this argument (see below), it is clear that other ways of strengthening local fiscal systems are possible and infinitely more desirable for the municipalities themselves, as well as for the federal system viewed as a whole. These can be summarized as follows:

Equalizing the Legislative Scales.—Municipalities, and especially the larger ones, are grossly under-represented in most state legislatures. An equitable reapportionment of legislative seats would go far toward decreasing the real and imagined discrimination against municipalities in the allocation of state-collected taxes. Reapportionment would also have the desirable result of minimizing the covert warfare between cities and states and of focusing the attention of officials at both levels on their common purpose.

Enlargement of Municipal Areas.—The consolidation of local governments is, in the long run, a most important step in the direction of strong local governments, economically and functionally. It is fiscal and functional insanity to maintain 155,000 local governments—most of which are special-purpose taxing units—in the United States. The pattern of small, overlapping, tax-deficient local governments produces inequities in tax burdens; makes it impossible for most local governments to achieve either economical or efficient administrations; dissipates political responsibility; thwarts, rather than promotes, citizen control of local institutions; and forestalls community-wide action to meet community-wide problems. Enlarging municipalities and consolidating within them the pyramidal taxing jurisdictions would have many beneficial effects. Widespread consolidations would go a long way toward producing cities with large enough populations to permit the effective administration of public services and with enough wealth to support a substantial portion of those services.

Freeing Cities from Legal Bondage.—The traditional system of state supervision over municipalities consists, in Wylie Kilpatrick's words, of "an amazing assortment of constitutional and statutory regulations which often minutely restrict communities when they should be free and omit regulation when administrative guidance would be helpful." [19] Municipalities are the legal

[18] This point is as applicable to the states in their relationship with the national government as it is to the municipalities in their relationship to the states.

[19] *State Supervision of Local Finance* (Publication 79, Public Administration Service, Chicago, 1941), p. 47.

creatures of the state. This position puts cities at the mercy of state legislatures in the absence of constitutional restrictions on legislative action and often in spite of those restrictions.

Genuine advantages to both states and localities would result from provisions that would free state legislatures from their preoccupation with special and local legislation and simultaneously grant greater discretionary authority to municipalities. Whether or not this is accomplished through constitutional "home rule" is relatively immaterial. Home rule, as pointed out above, cannot be an absolute matter, and the various systems of constitutional home rule work not at all in some states and only feebly in others.

What is needed is a legal framework of state-local relations that will (a) allow localities to meet their own local situations without waiting for a grant of authority from the state legislature and (b) allow state legislation directly affecting local affairs (virtually all state legislation *indirectly* does) only when it affects *all* municipalities. These objectives can be obtained from a system of general laws, though a few constitutional provisions following the Wisconsin model, for example, undoubtedly make them more certain.

"Constitutional home rule" is meaningless if it is not effectuated by the legislature or if it is emasculated by the courts. Yet "constitutional home rule" is again a popular slogan of municipalities.[20] The end sought, if appropriately qualified, is a highly desirable one. Yet its attainment is not solely contingent upon constitutional provisions. A power, for example, that all municipalities need—but few have—is that of freely forming contractual relations with other local governments for the provision of joint functions. This is attainable in most states through legislative action. The danger exists that the very real benefits that can be gained from legislation, and especially through general, permissive laws, will not be achieved while municipal officers concentrate on the semantic will-o'-the-wisp of constitutional home rule.

State-Municipal Administrative Cooperation.—The further refinement and development of state administrative supervision over local governments is still another means of lending vigor to municipalities and of achieving effectiveness in the administration of joint, state-municipal programs. As a substitute for legal restrictions on localities, administrative supervision has the potential advantages of being more efficient from the viewpoint of state programs and of allowing a far wider scope of flexibility to local governments. These potential advantages become actual only when the state supervisory personnel is itself of high professional competence, and only when state legislatures allow the state administrative bodies sufficient freedom of action. The appropriate supervisory technique in almost every instance is that of providing technical advice and assistance. Through a process of mutual consultation and education, state programs can best be effectuated. The indirect, as well as the direct, results in terms of municipal services can be highly beneficial.

The Alternatives: Fiscal Measures

The measures outlined above would

[20] See *National Municipal Policy for 1949*, cited above.

bring many benefits to municipalities. These measures would improve the fiscal situation of American cities; and they would contribute to vigorous and more effective local government, raising cities to a position in which the freedom and responsibility they seek can be turned to maximum public service. The fiscal program best designed to foster this development can be stated in the following terms:

Increasing the Yield of the Property Tax.—There is still a tremendous gap between what the property tax does, and what it might, yield. Property is the most appropriate tax base for cities; and improved assessment, collection, and enforcement procedures could materially increase the cities' revenue from the property tax.

A far greater yield from property taxes can be achieved by purely local action. The administration of property taxes is woefully weak in many states. But it is a striking commentary on the interdependence of states and cities that even measures to increase the yield of the principal local tax revenue, the property tax, depend upon cooperative action between states and cities. This can be expressed in the form of technical assistance from state administrators. Statutory and constitutional changes are also necessary before the property tax can reach its fullest utility. This is especially true with respect to the use of special assessments, the introduction of classification plans, the removal of arbitrary tax limits, and the curtailment of excessive tax exemptions.

Loan Receipts and Reserve Funds.—State legislation is also necessary to allow all municipalities to accumulate reserve funds during prosperity and to use these funds freely for local purposes. Similarly, state action could be important in guaranteeing to municipalities a ready source of borrowed funds at low interest rates. The careful utilization of both surpluses and loan receipts can be of great value in strengthening the fiscal situation of cities.

Local Non-Property Taxes.—Non-property taxes should be used by municipalities only to a very limited extent. The smaller the municipality, the more true this tends to be. Some of these taxes, e.g., the admissions tax, are peculiarly well-adapted to local collection. Others, e.g., various service fees, are justified in terms of special services rendered to particular classes of residents. But the grave disadvantages of the vast majority of municipal non-property taxes have been pointed out in the preceding paragraphs.

Grants-in-Aid and Shared Taxes.—All the measures sketched above, including those aimed directly at improving the fiscal strength of municipalities, will probably not be sufficient to supply municipalities with the revenues needed to carry their ever-increasing functional load. This is particularly true for the immediately foreseeable future. The cities in the short run desperately need additional revenues. And it is at this point that the argument is made for the various municipal non-property taxes.

Expanded and refined systems of state grants-in-aid and locally shared state taxes are clearly preferable to the multiplication of local non-property taxes. The states, by virtue of their very size, are better suited than municipalities to be revenue collectors. They can develop, from their own resources and from their position as channelers of

Federal funds in the national system of intergovernmental grants, revenue and loan receipt programs that avoid the inherent defects of numerous local non-property taxes.[21] The states' responsibility for supplying state-collected funds to municipalities springs, essentially, from the common purposes of states and municipalities. And this responsibility has been institutionalized in many ways: in the use that states make of cities as vehicles of administration; in the practice of states in establishing minimum standards of performance, thus obligating local expenditures; in the limitations states impose on local taxation and borrowing; in the very legal superiority of states over municipalities.

State-aid programs can do two things that the proliferation of local taxes cannot do. The aid programs can stabilize local revenues at adequate levels, and they can relieve localities from the burden of sharp expenditure increases during periods of depression.

State-aid programs have many further advantages. They can be coupled with the establishment of minimum standards of performance and with programs of technical advice and assistance. They can be designed consciously to increase the taxable wealth of municipalities (as in housing and industrial development programs), thus contributing to the development of sound local revenue systems. They can be used to eliminate those units of local government which are archaic, inefficient, and representative of no genuine community interests, and thus can aid in the development of municipalities that are large enough and wealthy enough to achieve effectiveness of operation and a progressively greater fiscal sufficiency. They can be used in accordance with principles of local fiscal capacity and local fiscal need.[22] They can further cement the bonds of common purpose that exist between governments at both the state and local levels, and between them and the Federal Government.

Role of the Federal Government

The last point deserves emphasis. Just as a citizen of a municipality is a citizen of his state, so is he a citizen of the United States. Advances in technology (e.g., the disappearance of the frontier as a result of new modes of communication) and changes in the economy and in the public conscience (e.g., the demand that government take responsibility for the care of the aged) have made this common citizenship at once more apparent and more the concern of all citizens, everywhere. The history of government in the past half century has been the history of big government at the center becoming ever more concerned with problems that once were the exclusive province of small governments at the periphery. This has inevitably been accompanied by the assumption of greater revenue-raising burdens

21 Vast improvements are needed in the states' own fiscal programs. Most importantly, state taxes are heavily regressive and fiscally perverse. And the policy of stringently limiting state debts by constitutional provision is unsound, both fiscally and politically. It is fiscally unsound because it makes countercyclical financing impossible. It is politically unsound because, during depression, it leaves the states so dependent upon Federal financing that it invites the very centralization the governors oppose.

22 Local non-property taxes, of course, are most productive in the wealthiest areas and cannot bring fiscal relief to those municipalities that need it most. For those grants given to equalize resources or to insure the maintenance of service standards, it is feasible to construct tests of municipal wealth and municipal tax effort and to allocate grants accordingly.

by the central government and the disbursement of some of those revenues to other governments for specified purposes in the national interest. This course of action has been validated by the votes of free people; so long as those people remain free, there seems little likelihood that the trend will be reversed.

In terms of fiscal programs, this says only that just as the states must, and should, continue to supply fiscal aid to municipalities, so the national government must, and should, supply aid to the states. The national government is far less subject to economic stress than the state governments. Even during depression the national government has tremendous resources to levy progressive taxes, to borrow, and to create its own deposits through the Federal Reserve System. It is difficult to foresee any future in which national grants to states will not continue to exist and will not carry with them beneficent effects in terms of the services citizens receive and in terms of the strength of the component units of the federal system.

The Complexity of Federalism: Wrong Answer to the Hard Question

Constitutional lawyers are fond of saying that hard questions make bad law. The fiscal plight of cities confronts American federalism with a hard question. The total pattern of analysis presented above indicates strongly that the answer being evolved (in the form of statute, ordinance, and practice) is the wrong one. The policy of expanding municipal non-property taxes is, in the long run, self-defeating for the cities and, by that very fact, damaging to the Federal system.

It is the crisis nature of the situation facing cities that makes the wrong answer seem the only one to the people working out that answer. The factors discussed above play their role; both state and local officials define the situation in particularist terms; both lag behind (a typical sociological phenomenon) in recognizing the degree to which the several levels of government are basically interrelated; both strive for power and for functional autonomy, their motives being only partially related to the stated rationale. But over and above these factors, the squeeze on the city finances is a very real one. And, most importantly, the alternatives to enlarged local taxing powers are difficult to achieve. They are blocked by the whole legal gamut of a complex federalism; [23] by political considerations arising from interlevel government; and by the very parochialism of both local and state officials. The last point has a special importance in the cycle of action. The factors leading to the multiplication of local non-property taxes are also those factors blocking consideration of such measures as the careful working out of schemes for locally imposed, state-collected taxes or for the consolidation of local governments.

In such a situation, the increase in local non-property taxes is seized upon. Better ways of solving local fiscal problems may be acknowledged, but this way is, apparently, the only immediately feasible one. As one city official has put it: "The other solutions are wonderful. But in the interim, cities cannot live on love."

The point is well taken. But its

[23] A recent court decision in West Virginia, for example, has declared unconstitutional the state's sharing with municipalities profits from the state's liquor monopoly (54 S.E. 2d 729 [1949]).

short-run logic cannot deny its medium- and long-run consequences. Those consequences are dangerous.

There is, further, a good deal of self-defeatism in arguing for enlarged municipal taxes because other ways of solving the fiscal problems of cities are more difficult. The prediction of difficulty confirms itself.[24] When state and local officials tell themselves that the improvement of property tax administration (or any of the other programs outlined above) is hard to achieve, they by that very act tend to make it so. They succeed so completely that they divert their efforts from these programs in favor of the relatively easy — and undesirable — multiplication of local taxes.

A realistic assessment of the difficulty of achieving desirable state-local fiscal programs is, of course, a prerequisite to intelligent action. And no argument is made here that those programs are *not* difficult to establish. But it is argued that the good cannot be equated with the easy, and that the difficult is preferable when the easy is evil.

This puts a heavy burden upon state and local officials. Their problem is a joint one and its solution rests equally upon both. State officials face perhaps the heaviest responsibility because their position makes it easy for them to slide away from the problem. They can pay lip service to "local home rule," and simultaneously can comfort themselves with the knowledge that if the policy is wrong, local officials are digging their own graves. Yet the states' legal and fiscal superiority makes the problem no less a state than a local one.

In the long run, power lost by cities as the result of unwise fiscal policies will not revert to the states. Indeed, the states' position is even more vulnerable than the cities'. As a single integrated organism the states and municipalities may decline together during fiscal crisis. But, alternatively, the states may witness the proliferation of direct national-local programs, and the resuscitation of cities by national action. As middle men in the Federal system state officials have everything to lose and nothing to gain in abetting municipal fiscal systems whose total effect is to weaken municipalities.

All this adds up to a hard practical point. If the right solutions to local fiscal difficulties are difficult solutions, no purpose can be served by shying away from them. As a matter of fact, the solutions themselves are clear enough. What is lacking are means—specific steps through which the programs outlined above can be molded into law and action. These must be fitted to local situations. They will emerge only from the research of students and from the ingenuity, sensitivity, and intelligence of political and administrative leaders.

Summary and Conclusion: A Theory of Reverse Consequences

The principal contemporary means taken by states and localities to achieve "free, responsible local government" is through the granting of wide tax powers to municipalities and the consequent multiplication of local non-property taxes. The preceding pages have pointed out that this course of separatist action is rooted in the social-psychology of American state-local relations. It has been argued that this trend in fiscal relations is unwise.

[24] I am indebted to Professor Milton Singer of the University of Chicago for first introducing me to this concept.

It is unwise for a long series of important economic reasons. It is unwise because it separates governments at a time when the logic of public finance, the legal framework of state-local relations, and the development of government as a service institution in our culture all push in the direction of cooperative government action.

The multiplication of municipal nonproperty taxes is unwise, most of all, because it will produce results contrary to its objective of "free, responsible local governments." The probable depression results of dependence on these taxes all augur of reverse consequences. These include reduction in the quantity and quality of municipal services and the widespread transfer of local functions to higher levels of government.

These possibilities are directly courted by the rapid extension of municipal taxes. They are indirectly courted by the emphasis of both states and localities on promoting these taxes, thus diverting their interest from more solid, if politically more difficult, avenues of approach to vigorous, local self-government.

The freedom and responsibility currently sought by American municipalities is not the freedom and responsibility to declare their own demise. Rather, it is to maintain and increase their effectiveness for the populations they serve.

EVOLUTION OF THE SPECIAL LEGAL STATUS OF CAPITAL GAINS UNDER THE INCOME TAX

LAWRENCE H. SELTZER *

Harvest Tradition of Income

THE CONCEPT of income that has come down to us from the past took its character from agriculture as practiced in the temperate zone. In a predominantly agricultural economy, income appears to be a physical fact and to consist of the annual harvest or its worth in money. Capital also appears to be a physical fact: it is the land, predominantly.

The formal concepts of income evolved by economists during the eighteenth and most of the nineteenth centuries, though generalized in form, were based squarely upon the nature of agricultural income.[1] Income arises from purposeful economic activity, such as farming, and recurs fairly regularly with the elapse of time, e.g., with the passage of the seasons. It arises from a fixed and continuing source, such as a farm or landed estate. Like the annual harvest, it is given off by or separated from this fixed source and becomes available for independent disposition or consumption without impairing the source. Strongest of all these traditional earmarks of income is the tendency to recur at more or less regular intervals.

Casual, sporadic, and unexpected gains, whether derived from the sale of land, other property not ordinarily dealt in by the recipient, gifts, or otherwise, did not fit into this concept of income. They appeared to be the result of good luck, not the usual product of purposeful activity. Lacking a continuing source, such as a farm or business enterprise, they arose from discrete events. Hence they could not reliably be expected to recur at regular intervals. A prudent man, the conclusion was, will therefore regard them differently from ordinary income. He will treat them as additions to his capital, not available for ordinary consumption. Capital gains in this view included all unexpected receipts.

Concept of Income Designed for Entailed and Trust Estates

The need for a legal concept of income first arose in connection with the common practice of landowners in England and on the Continent of entailing their estates; that is, of limiting the inheritance of an estate to a specified line of heirs so that the estate could not be sold by any one of them or bequeathed at his pleasure. In effect, each succeeding heir was entitled only to the income from the estate during his lifetime, not to any part of the principal. The courts had to distinguish between

* The author is professor of economics, Wayne University. The materials for this article were drawn from a study made under the auspices of the National Bureau of Economic Research, Inc. The complete study, entitled *The Nature and Tax Treatment of Capital Gains and Losses,* will, it is expected, be published by the Bureau shortly.

[1] See P. H. Wueller, "Concepts of Taxable Income," a series of four articles in the *Political Science Quarterly,* LIII (March, June, September, and December, 1938).

income and principal in the sense of what could be rightfully consumed by the life-tenant as against what belonged to the *corpus* or body of the estate.

The resulting legal concepts of capital and income were evolved at a time when landed property comprised the bulk of all durable property. The courts adopted the view that a man's capital or estate, usually a farm or group of farms, was a physical entity, and the income from it, its separable fruit or harvest. Increases in the capital value of an entailed estate could not be regarded as income of the life-tenant. What had been left to him was a life-interest in specific pieces of physical property, not in a given capital value. He had no right to sell any part of the estate and hence he could not "realize" a gain in value if it occurred. Hence there was no useful sense in which appreciation in the value of the estate could be considered income. For similar reasons, declines in value did not reduce the income allotted to the life-tenant.

Where property was not entailed or transferred in trust, the question whether a rise or fall in value, realized or unrealized, should be regarded as an element of income was of small practical importance because of the general immobility of ownership and the absence of income taxes.

Since the estates of the propertied classes in postfeudal Europe were commonly entailed, a man's wealth was better measured by his income than by the capital value of the property from which he drew it. And the kind of income that was significant for this purpose was the income that could be reasonably expected, the more or less recurring income, not unforeseen, sporadic gains. Hence in England and in Europe generally it became traditional to measure a man's economic position not by the principal amount of his estate, but by the amount of his recurring annual income. "Smith is worth £ 2,000 a year" illustrates the type of measure of wealth that persists in England to this day.

Physical Concept Applied to Securities

When securities and salable real estate came to constitute important parts of trust estates, the courts had to choose between assigning to the life-tenant as income or to the remainderman as principal the profits realized on sales of assets. Had it been common to think of capital or principal as a pecuniary quantity, the estate to be safeguarded might have been conceived as consisting of a given capital value, with all additions thereto being viewed as income available for consumption. Even unrealized changes in the market value of the items comprising the estate might conceivably have been taken into account in arriving at the income available for the holder of a life-interest.

But this, we have seen, was not the case. The dominant position long held by landed property had fostered the concept of capital as a physical thing. As against the fairly elaborate accounting practices needed to administer a pecuniary or quantitative concept of capital, most owners of property kept only primitive and scanty financial accounts until a century or so ago. Although government bonds and some other securities were bought and sold to a limited extent through stockbrokers long before the organization of the London Stock Exchange in 1773, such

securities were only a tiny and unrepresentative fraction of accumulated private wealth. For most capital assets —primarily landed properties—ready markets did not exist and sales were infrequent.

In these circumstances it is not surprising that, instead of regarding securities as quantities of pecuniary value, measured by cost or market price, the courts applied to them the same physical concept of capital or principal that they had long applied in the administration of landed estates.[2] A government bond in which the purchaser had invested £ 1,000 was regarded as a *res,* a thing. The capital investment was not the quantity of money that had been paid for the bond, or its market value, but the bond itself. Hence a rise or fall in the value of the bond did not change the investment and was not an element of income. If gains were realized on the sale, these were regarded as nonincome " accretions to capital " in much the same way as an accretion was said to take place to a piece of land when, in the course of time, a water boundary receded. Since the capital investment was regarded as a thing, not a pecuniary quantity, the " maintenance of capital " did not require the maintenance of its value. The entire receipts from interest payments constituted income even if the value of the bond fell below its cost and it was sold at a loss. The retention to this day of the *res* concept of capital in the administration of various trust estates, despite a clear recognition of its alternative, was emphasized by an American court in 1927:

> What is the principal or corpus of the estate in cases of this kind? Is it the corporate stock, itself, or its *value* at a given time? Undoubtedly the former. If the trust estate were land, the fact would be clear.[3a]

By dint of long usage the concept of a capital investment as a *res* or thing and the correlative view that a rise or fall in its value, realized or unrealized, is not relevant for determining income became thoroughly embedded in the law and traditions of England and various other countries. When the use of incomes as a base for taxes was gradually introduced in Great Britain and Europe, mainly during the nineteenth century, taxable income was commonly limited to the yields from specific continuing sources. The early European income taxes were not levied upon the total incomes of *persons,* but upon the net yields of various *sources* of income, the rates often varying with the source. Net yield taxes of this type, though they are now usually supplemented by general personal income taxes, are still levied in most European countries.

When Great Britain inaugurated income taxation in 1798 and when she adopted her present income tax system in 1842, the *form* of the tax was that of a levy on the yields from stated sources, but the effect was that of a *personal* income tax because the same rates were applied to incomes from all sources and because nearly all kinds of income were covered. But consistent with the *res* concept of an investment, though possibly for other reasons as well, capital gains were excluded. To this day Great Britain not only excludes both unrealized and realized capital

[2] See Nathan Isaacs, " Principal—Quantum or Res," *Harvard Law Review,* XLVI (1933), 776 ff.; Roswell Magill, *Taxable Income* (New York: Ronald Press, rev. ed., 1945), pp. 29, 40-42.

[3a] *Hayes* v. *St. Louis Union Trust Co.,* 317 Mo. 1028, 1043, 298 S. W. 91, 97 (1927).

gains and losses from the computation of income, but taxes annuities and income from British natural resources without allowing deduction for exhaustion of the asset; nor does she allow depreciation deductions from the income of apartment houses, commercial buildings, and similar structures.[3b] The British Royal Commission on the Income Tax defined the British position as follows:

> For Income Tax purposes, speaking in general terms, income is the surplus of receipts over the current expenditure necessary to earn those receipts, regardless of the appropriation of any part of the receipts or surplus for the purpose of writing off or amortising the capital value of any assets that waste in the process of producing the income. The only wasting assets for which an Income Tax allowance is now made are plant and machinery, and certain buildings that contain plant and machinery.[4]

The same concepts are reflected also in the British attitude toward impairment of a corporation's capital.[5] In the words of one British jurist:

> The law is much more accurately expressed by saying that dividends cannot be paid out of capital, than by saying that they can only be paid out of profits. The last expression leads to the inference that the capital must always be kept up and be represented by assets which, if sold, would produce it; and this is more than is required by the law. Perhaps the shortest way of expressing the distinction which I am endeavoring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided.[6]

Before World War I British practice also excluded from income tax the profits from isolated or infrequent transactions. This exclusion was in keeping with the agricultural tradition that confined the concept of income to regularly recurring receipts. It appeared to be in keeping, too, with the wording of the law, which applied to " annual " income. The British Income Tax Law does not expressly define income as such and does not cover all forms of income. It applies only to the types described in five " schedules." Schedules A, B, C, and E deal with income from specified sources, such as the rental value of lands and buildings and interest on government bonds. Schedule D applies to " the annual profits or gains arising . . . from any kind of property whatever . . ." and " from any trade, profession, employment or vocation," and to interest annuities " and other annual profits or gains not charged under Schedule A, B, C, or E, and not specially exempted from tax. . . ." The word " annual " had long been interpreted to exclude occasional isolated profits.[7] Opportunities to make sporadic, nonrecurring gains were exceptional during and immediately after World War I, and much indignation was aroused by the fact that such profits were escaping taxation.[8]

3b Some taxation of capital gains as income was introduced in the Income Tax Act of 1945. Patents were made depreciable, but gains from casual sales of them, previously exempt, were made taxable. Similarly, sales of machinery, etc. for more than their depreciated basis now occasion a taxable gain.

4 *Report of the Royal Commission on the Income Tax* (London: H. M. Stationery Office, 1920), par. 180.

5 See Wardhaugh, "Capital and Revenue—A Varying Distinction," *The Accountants' Magazine*, XXXIV, 289.

6 Lord Justice Lindley in *Verner v. General and Commercial Trust*, 1894, 2 Ch. 239, 266.

7 See George O. May, "The British Treatment of Capital Gains," *Journal of Accountancy*, June, 1942.

8 *Ibid.*

The Royal Commission on the Income Tax, which studied this matter, recommended as follows:

We are of the opinion that any profit made on a transaction recognizable as a business transaction, i.e., a transaction in which the subject matter was acquired with a view to profit-seeking, should be brought within the scope of the income tax, and should not be treated as an accretion of capital simply because the transaction lies outside the range of the taxpayer's ordinary business, or because the opportunities of making such profits are not likely, in the nature of things, to occur regularly at short intervals.[9]

But the commission distinguished such profits from those realized by " ordinary changes of investments " by saying:

Profits that arise from ordinary changes of investments should normally remain outside the scope of the tax but they should nevertheless be charged if and when they constitute a regular source of profit.[10]

These recommendations of the commission were not formally embodied in law. Instead, a vigorous and successful effort was made by the Board of Inland Revenue to reach the profits from single ventures of an obviously trading nature and those involving a series of transactions, each of which separately would not have constituted the carrying on of a trade.[11]

American Conditions Differed

Although the economy of the United States was predominantly agricultural in its early years, realized capital gains quickly took on a more conspicuous role in this country than they had abroad. Land was so plentiful and cheap that its ownership did not carry the same social prestige that it did abroad. The strong desire to keep the descent of land ownership along family lines that was so conspicuous in Europe was relatively weak in this country. The purchase and sale of lands and the accumulation of private fortunes through the profits from such transactions became common early in our history. On the other hand, long established and stable incomes from land rents and bond interest were rare. Later, the rapid succession of economic changes created by the great growth of population and the discovery and exploitation of natural resources produced frequent large increases in the market values of countless business enterprises and pieces of real estate. By reason of a high degree of mobility of business men and their capital, a considerable part of such value increases was converted into realized gains.

In many transactions gains from the sale of capital assets constituted the major type of profit contemplated. With little regard for the niceties of accrual accounting, profits were commonly sought and calculated on the basis of specific transactions. Opportunities for capital gains were in fact recurring. It became not uncommon for some business men to meet a part or even all of their consumption requirements from capital gains. In some sections of the country farmers acquired the reputation of buying their farms with only one eye on the income to be obtained from farming and the other fixed on the trend of land values.

In this environment capital gains became scarcely distinguishable from ordinary business profits for many business men and they became a familiar

[9] *Op. cit.*, par. 91.

[10] *Ibid.*, par. 90.

[11] May, *loc. cit.*

source of private wealth. At the same time, unlike the situation in England, the value of a man's principal or capital, rather than the income he derived from it, was generally adopted as the measure of his wealth. For these reasons the sharp distinction between ordinary income and capital gains that still prevails in England never obtained as strong a hold in the United States.

American Statutes before 1913

American jurisprudence inherited from the British common law the tendency to regard a capital investment as a *res* or thing, rather than as a quantity of pecuniary value equal to the original cost or market value. But when Congress expressly included the gains from capital assets in taxable income, the Supreme Court did not find this unconstitutional. The court did, however, establish the requirement that, to be taxable as income, the gains must be "realized." And in ruling on the earmarks of realization, it has tended to apply the *res* as against the value concept of capital investment.

The Revenue Act of 1862, the first tax measure of the Civil War period to become effective,[12] introduced an income tax "upon the annual gains, profits, or income of every person residing in the United States, whether derived from any kind of property, rents, interest, dividends, salaries, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, or from any other source whatever, except as hereinafter mentioned, if such annual gains, profits, or income exceed the sum of six hundred dollars. . . ."[13] Neither the act nor the regulations contained specific reference to capital gains and losses, though the language of the form for reporting the tax appeared to be broad enough to include them.[14] That profits on sales of real estate were taxable is known from the objections raised in Congress during the discussion of the Revenue Act of 1864 to a ruling of the Commissioner of Internal Revenue that profits from real estate were income in the year of sale even though they had accrued over a long period.[15] The 1864 act altered this treatment by providing that gains and losses from sales of real estate should be taken into account in determining taxable income only when realized from property that had been acquired within the preceding year, but expressly included in "the annual gains, profits, or income" to be taxed "all income or gains derived from the purchase and sale of stocks or other property, real or personal. . . ."[16] In 1867 the law was amended by dropping the word "annual" from the general definition of "the gains, profits or income" to be taxed; by omitting the clause quoted in the preceding sentence under which gains from the purchase and sale of stocks or other property were specifically included; and by including gains from real estate acquired during the two preceding years.[17]

[12] The first act passed, that of 1861, never went into effect.

[13] Revenue Act of 1862, sec. 89, Public No. 97, 37th Cong., 2d sess., ch. 119, 12 Statutes.

[14] C. F. Estee, *The Excise Tax Law* (New York: Fitch, Estee, and Co., 1863), contains a copy of the income tax regulations and an outline for the form for reporting.

[15] J. S. Seidman, *Legislative History of the Federal Income Tax Laws, 1861-1938* (New York: Prentice-Hall, 1938), p. 1028, cites to this effect the *Congressional Globe*, 38th Cong., 1st sess., p. 2516.

[16] 13 *Stat. L.* 223.

[17] 14 *Stat. L.* 471-87.

In a famous case interpreting the Civil War Income Tax Act of 1867—*Gray* v. *Darlington*,[18] decided in 1872—the Supreme Court decided that profits of $20,000 realized by an investor in 1869 on the sale of United States Government bonds he had owned for four years were not taxable as income. The court said:

> The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits, and income. Its general language is "that there shall be levied, collected, and paid *annually* upon the gains, profits, and income of every person. . . ." This language has only one meaning, and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year. There are exceptions, as already intimated, to the general rule of assessment thus prescribed. One of these general exceptions is expressed in the statute and relates to profits upon sales of real property, requiring, in the estimation of gains, the profits of such sales to be included where the property has been purchased, not only within the preceding year, but within the two preceding years . . . . Except, however, in these and similar cases, and in cases of sales of real property, the statute only applies to such gains, profits, and income as are strictly acquisitions made during the year preceding that in which the assessment is levied and collected.
>
> The mere fact that the property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.
>
> The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place. We are satisfied that no such result was intended by the statute.

Although some of the language of the opinion, particularly in the second of the three paragraphs reproduced above, reflects the traditional British distinction between income and an accretion to capital, the actual decision appears to have been based squarely upon the wording of the statute.[19] Except for gains from real estate acquired within two years, the statute was interpreted to apply only to annual or recurring gains. It is noteworthy that the court did not condemn the inclusion of the specified real estate gains in taxable income.

The Revenue Act of 1870,[20] which was nearly identical with that of 1867 in its definition of income, was the last of the Civil War income tax laws. After it expired in 1873, Congress did not reimpose an income tax until 1894, when a measure was enacted under which taxable income was defined, in part, as in the 1867 act, as "the gains, profits, and income . . . whether said gains, profits, or income be derived from any kind of property, rents, interest,

[18] 15 Wall. 63 (1872).

[19] Magill, *op. cit.*, pp. 103-04.

[20] 16 *Stat. L.* 256-62.

dividends, or salaries . . . or from any source whatever." [21] Gains from the sale of real estate acquired within two years and the money value of gifts and inheritances were specifically included. But the Supreme Court, by a five to four decision in *Pollock* v. *Farmers' Loan and Trust Company*,[22] held the act unconstitutional on the ground that the tax was a direct tax which could be valid only if apportioned among the states in proportion to population.

Fourteen years later Congress accommodated itself to this decision, as far as a tax on corporation incomes was concerned, by enacting the Corporation Excise Tax Act of 1909, under which the tax was nominally imposed for the privilege of doing business in corporate form, but the amount of the tax was measured by 1 per cent of the net income in excess of $5,000.[23] This law was found constitutional.[24] In a leading decision interpreting it,[25] the Supreme Court enunciated a definition of taxable income that it subsequently repeated many times:

> Income may be defined as the gain derived from capital, from labor, or from both combined.

In three other decisions under the 1909 act, all handed down on the same day in 1918, the Supreme Court upheld the inclusion in taxable income of realized gains derived from the appreciation of property values. In *Doyle* v. *Mitchell Brothers Company*,[26] in which a lumber dealer contended that the proceeds of its sales largely represented a rise in the value of its capital assets, not a taxable gain, the court said:

> The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received "from all sources."
>
> . . . In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

In *Hays* v. *Gauley Mountain Coal Company*,[27] the defendant company had realized a gain of $210,000 in 1911 on the sale of stock in another company acquired nine years before. The court held that the excess of the sales price over the value on December 31, 1908, constituted a taxable profit, and a decision to the same effect was rendered in *U. S.* v. *Cleveland, C., C. & St. L. Ry. Co.*[28]

Realized Capital Gains as Income

The Sixteenth Amendment to the Constitution was ratified on February

[21] 28 *Stat. L.* 553-69.

[22] 157 U. S. 429, 15 Sup. Ct. 673 (1895); on rehearing 158 U. S. 601, 15 Sup. Ct. 912 (1895).

[23] 36 *Stat. L.*, 113-18.

[24] *Flint* v. *Stone-Tracy Company*, 220 U. S. 107, 31 Sup. Ct. 342 (1911).

[25] *Stratton's Independence, Ltd.* v. *Howbert*, 231 U. S. 399, 34 Sup. Ct. 136 (1913).

[26] 247 U. S. 179, 38 Sup. Ct. 467 (1918).

[27] 247 U. S. 189, 38 Sup. Ct. 470 (1918).

[28] 247 U. S. 195, 38 Sup. Ct. 472 (1918).

25, 1913. The present-day series of income tax laws begins with the first act passed under it, that approved on October 3, 1913, effective as of March 1, 1913.[29] In this act, net income was defined in the following paragraph, the substance of which has been repeated in the subsequent acts:

That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation, or personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits, and income derived from any source whatever.

In a series of notable decisions in 1920 and 1921, the Supreme Court crystallized its interpretation that the word "income" includes capital gains.

In *Eisner* v. *Macomber*,[30] decided in 1920, Justice Pitney, speaking for the majority, declared:

For the present purpose, we require only a clear definition of the term "income" as used in common speech, in order to determine its meaning in the Amendment; . . . after examining the dictionaries in common use . . . we find little to add to the succinct definition adopted in two cases arising under the Corporation Act of 1909. "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets.

[29] 38 *Stat.* 166.

In *Merchant's Loan and Trust Company* v. *Smietanka*,[31] decided in 1921, the court held that the word "income" in the Sixteenth Amendment included a gain from a single isolated sale as well as profits from sales by one engaged in buying and selling as a business. The court said:

It is sufficient to say of this contention, that no such distinction was recognized in the Civil War Income Tax Act of 1867, c. 169, 14 Stat. 471, 478, or in the Act of 1894, c. 349, 28 Stat. 509, 553, declared unconstitutional on an unrelated ground; that it was not recognized in determining income under the Excise Tax Act of 1909, as the cases cited, *supra*, show; that it is not to be found, in terms, in any of the income tax provisions of the Internal Revenue Acts of 1913, 1916, 1917, or 1919; that the definition of the word "income" as used in the Sixteenth Amendment, which has been developed by this Court, does not recognize any such distinction; that in departmental practice, for now seven years, such a rule has not been applied; and that there is no essential difference in the nature of the transaction or in the relation of the profit to the capital involved, whether the sale or conversion be a single, isolated transaction or one of many. The interesting and ingenious argument, which is earnestly pressed upon us, that this distinction is so fundamental and obvious that it must be assumed to be a part of the "general understanding" of the meaning of the word "income" fails to convince us that a construction should be adopted which would, in a large measure, defeat the purpose of the Amendment.

The court declared further:

In determining the definition of the word "income" thus arrived at, this court has

[30] 252 U. S. 189, 40 Sup. Ct. 189 (1920).

[31] 255 U. S. 509, 41 Sup. Ct. 386 (1921).

consistently refused to enter into the refinements of lexicographers or economists and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution.

The British income tax decisions are interpretations of statutes so wholly different in their wording from the acts of Congress which we are considering that they are quite without value in arriving at the construction of the laws here involved.

Accrued but Unrealized Capital Gains and Losses

On the question whether an unrealized appreciation in the value of an asset may be taxed as income the Supreme Court has consistently ruled in the negative. In *Towne* v. *Eisner* a unanimous court declared that stock dividends were not intended by Congress to be taxed as income under the Revenue Act of 1913.[32] The 1916 act specifically included the cash value of stock dividends in taxable income. When the Standard Oil Company of California distributed a 50 per cent stock dividend in 1916, charging the dividend against its accumulated surplus account, one stockholder paid under protest a personal income tax on that part of the value of the dividend which represented corporate profits accumulated after March 1, 1913, and sued to recover the amount on the ground that the stock dividend was not income. In a famous five to four decision in *Eisner* v. *Macomber*, the Supreme Court held on constitutional grounds that income, to be taxable, must be realized, and that a stock dividend is not a realization.[33]

[32] 245 U. S. 418, 38 Sup. Ct. 158 (1918).

[33] 252 U. S. 189, 40 Sup. Ct. 189 (1920).

The court declared: " neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder." Among other things, the court said:

> We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.
>
> . . . without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.
>
> . . . Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term.

The court made liberal use of italics to emphasize that to constitute income the gain must be separated from the capital:

> Here we have the essential matter: *not* a gain accruing to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *derived*, that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property.

As Professor Magill has pointed out, the decision does not explain the court's reasons for holding why a mere growth in the value of an investment cannot be regarded as income; why a gain, to be income, must be severed from capital.[34] Professor T. R. Powell, in an often-quoted comment upon this decision declared:

> Nothing in the nature of things makes separation from capital one of the requisites of income from capital. From a practical commonsense point of view, there is something strange in the idea that a man may indefinitely grow richer without being subject to an income tax.[35]

In accordance with the court's decision, Congress expressly provided in the Revenue Act of 1921 and in subsequent revenue acts until 1936 that "a stock dividend shall not be subject to tax." The Treasury interpreted this to mean that a corporation might issue any class of its own stock as a dividend to its stockholders without subjecting the latter to income tax on it.[36] The common stockholders might receive a tax-free dividend of 6 per cent preferred stock, for example. But in 1936, in *Koshland* v. *Helvering*, the Supreme Court declared: "where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented, he receives income," and "the latter type of dividend is taxable under the Sixteenth Amendment."[37] Congress promptly removed the blanket statutory exemption it had apparently granted to stock dividends since the Macomber decision of 1920, and replaced it with one reading as follows:

> A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

The Treasury Department soon brought a case before the Supreme Court in which the issues decided in *Eisner* v. *Macomber* might be reconsidered.[38] The court, however, on the ground that Congress had not intended to tax the stock dividends in question, refused to reconsider the Macomber decision. A minority of the court, nevertheless, was ready to do so. Speaking for the minority of three justices, Mr. Justice Douglas declared:

> The wealth of stockholders normally increases as a result of the earnings of the corporation in which they hold shares. I see no reason why Congress could not treat that increase in wealth as "income" to them. . . . The notion that there can be no "income" to the shareholders in such a case within the meaning of the Sixteenth Amendment unless the gain is "severed from" capital and made available to the recipient for his "separate use, benefit and disposal" . . . will not stand analysis. . . . The narrow question here is whether Congress has the power to make the receipt of a stock dividend based on earnings an occasion for recognizing that accrual of wealth for income tax purposes.[39]

Rationale of the Realization Doctrine

The Supreme Court's insistence that a capital gain must be realized in order

[34] *Op. cit.*, p. 18.

[35] "Income from Corporate Dividends," *Harvard Law Review*, XXXV, 363, 376.

[36] Articles 115-18, Treas. Reg. 86 (1934).

[37] 298 U. S. 441, 56 Sup. Ct. 767 (1936).

[38] *Helvering* v. *Griffiths*, 318 U. S. 371, 63 Sup. Ct. 636 (1943).

[39] *Ibid.*, at 409-11.

to be taxable as income is consistent with the traditional judicial view that a taxpayer's capital investment consists of the thing, the *res*, rather than its value; the land or factory building or share of stock or bond, not its money cost or its market price. As long as the gain is embodied in the same investment entity, the taxpayer is said to have nothing more than he had before. When it is separated from this entity or when the investment is sold, the gain constitutes taxable income. In holding that realized capital gains are income, however, the Supreme Court has applied the *res* concept in less extreme form than the British. The latter have continued to regard realized, like unrealized gains, as mere " accretions to capital ": what the seller receives is only the money value of the investment entity he possessed before; the entire proceeds of the sale merely replaces the capital investment he gives up.

As we have observed, the *res* concept was convenient in an agricultural economy with only rudimentary accounting practices. Under present conditions it is much less so. A landed estate could once be presumed to last forever. But much of present-day capital equipment has a relatively short life. To determine net income now requires pecuniary appraisals of the amounts of capital value used up through the depreciation and obsolescence of assets, even when the latter retain the same physical dimensions as before. Stocks and bonds now form a major part of private property, and these are passed frequently from hand to hand by transient owners, quite unlike the landed estates of postfeudal England. Their market value is often their most significant aspect for the investor. A rise in their value gives him the same addition to his command over economic goods and services as an equal addition to his savings from other sources; a fall, the same decrease.

For these reasons, outside the courts, the physical aspects of capital and income have receded into the background and the pecuniary or value aspects have assumed predominance. A man's capital today tends to be regarded as a quantity of pecuniary value that may be shifted from one investment to another. And because the investment is viewed as a quantity of value, not as a thing or series of things, the ancient judicial distinction between income and an " accretion to capital " now sounds archaic to laymen and is not always intelligible to them. The *res* concept of capital gives rise to such anomalies in England as the nonallowance of depreciation in the determination of taxable income from buildings other than factories, and the nonrecognition of deductions for depletion. In the modified form in which the concept has been applied in the United States such anomalies are greatly reduced. But the requirement that gains must be " realized " to be taxable frequently produces highly unequal tax treatment of individuals who realize and those who do not realize their gains. For example, a man whose $5,000 investment in an industrial enterprise becomes worth $5 million during his lifetime may leave his fortune to his children without ever paying an income tax on the amount of the increase if only he does not sell the stock or trade it in a taxable exchange. (Of course he will have been subject to income tax on any cash dividends and certain stock dividends he may have received on his investment.)

In accordance with the value concept of a capital investment, many economists contend that income in the sense of a man's ability to contribute to the support of government properly includes both the amount of his consumption expenditures and all net additions to the value of his property during a given period. Professor R. M. Haig's definition that "Income is the money value of the net accretion to one's economic power between two points of time"[40] is of this character. So is Henry Simon's view: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question."[41] Georg Schanz proposed a similar view in Germany in 1896.[42] If unrealized gains are not to be regarded as taxable income, we face the anomaly, to repeat the words of Professor Powell, "that a man may indefinitely grow richer without ever being subject to income tax."

Nevertheless, no one can contend that the popular conception of income includes unrealized or "paper" profits and losses. The income tax statute depends for its successful administration upon the cooperation of millions of individual and corporate taxpayers, each of whom is responsible for making out his tax return. The content of the term "income" should therefore approximate what an intelligent layman would ascribe to it. Even if the popular conception were altered through education and experience to include unrealized gains and losses, the difficulties of administering a concept of income that required an appraisal of every taxpayer's assets each year would be forbidding. The liquidation of capital assets often involves substantial costs, and the market value of a small amount of a given asset, say 100 shares of X Company common stock, sometimes offers no reliable measure of the price that could be obtained if a much larger amount had to be sold. For these and other reasons, the valuations would in many cases have to be conjectural and therefore subject to dispute; and the accounting and auditing requirements of both taxpayers and tax enforcement officials would be multiplied.

Nor is the popular conception without merit. Changes in the market values of capital assets often represent merely transitory fluctuations that are soon reversed. To take account of all such changes might entail much burdensome bookkeeping with little net result. Even when a rise in value appears to be more lasting, the taxpayer who does not sell might suffer great inconvenience or injury if he had to account for his imputed gain under the income tax in the year in which it arises. The sale of a portion of his asset to raise funds to pay the tax might be impractical or unduly costly. In short, we might wholly agree with the general validity of the position taken by the economists cited in the foregoing paragraph, but nevertheless hold that the appropriate and convenient time at which to take account of changes in the value of a man's

40 "The Concept of Income," in *The Federal Income Tax* (New York: Columbia University Press, 1926), chap. 1.

41 *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), p. 50.

42 "Der Einkommenbegriff und die Einkommensteuergesetze," *Finanz Archiv*, XIII (1896), 23.

property is when he realizes the gains or losses.

What constitutes "realization," however, is a critical question. If only sales for cash were deemed to occasion the realization for tax purposes of a capital gain, the door would be opened wide for avoiding taxes on capital gains. Since most sellers of capital assets sooner or later reinvest rather than consume the proceeds, they could contrive, possibly with the aid of third parties, to have their sales take the form of exchanges of some types of capital assets for others. In this way a man might exchange a parcel of real estate for marketable securities having a value several times the cost of the real estate to him, without technically realizing a gain. If an investor desired to take his profits in General Motors common stock and to shift his funds to Bethlehem Steel common, he might have a broker arrange an exchange, rather than a sale and purchase, and so avoid realizing a taxable gain. Or a corporation might distribute its accumulated profits to its stockholders by means of dividends consisting of marketable shares of preferred and common stocks in subsidiary or affiliated or even unrelated corporations, without subjecting its stockholders to income tax liabilities on the distributions.

But the Supreme Court, by a broad construction of "realization," removed most of these possibilities of avoiding income taxes on capital gains. In *Peabody* v. *Eisner* it held that the gain need not be realized in money, but might also occur in connection with the receipt of property having an exchangeable value.[43] Exchanges of property, no less than sales, may give rise to taxable gains. The court's ruling in 1920, that the receipt of a stock dividend in the Macomber case did not constitute taxable income to the stockholder even though the dividend represented accumulated profits, has been of much narrower application than was at first supposed. In a series of important cases involving new securities received by stockholders in connection with corporate reorganizations, decided between 1921 and 1925,[44] the court held that the stockholders realized taxable income when they received securities differing in kind or extent from their previous holdings.[45] When a gain previously accrued was realized by being separated from the investment, the gain was held to be taxable income even if the value of the investment declined by an amount corresponding to the gain. This was the situation of the stockholders of the Prairie Oil and Gas Company who were held to be liable for income tax on the value of the stock they received in a new pipe line company when the parent company created the new company to separate its pipe line business from its oil and gas operations, and distributed the new company's stock *pro rata* to its stockholders.[46] In short, the realization doctrine has functioned in practice not so much as a denial that unrealized gains are truly gains, but to determine the appropriate time or occasion for taking

[43] 247 U. S. 347, 38 Sup. Ct. 546 (1918).

[44] *U. S.* v. *Phellis*, 257 U. S. 156, 42 Sup. Ct. 63 (1921); *Rockefeller* v. *U. S.*, 257 U. S. 176, 42 Sup. Ct. 68 (1921); *Cullinan* v. *Walker*, 262 U. S. 134, 43 Sup. Ct. 495 (1923); *Weiss* v. *Stearn*, 265 U. S. 242, 44 Sup. Ct. 490 (1924); and *Marr* v. *U. S.*, 268 U. S. 536, 45 Sup. Ct. 575 (1925). See Magill, *op. cit.*, for a brief account of these cases.

[45] James Parker Hall, "Exchange of Securities in Corporate Reorganization as Income," *Illinois Law Review*, XX (1926), 601.

[46] *Rockefeller* v. *U. S.*, 257 U. S. 176, 42 Sup. Ct. 68 (1921).

account of them for tax purposes. The principal exceptions are that transfers of property at death or by *inter vivos* gifts are not regarded as occasioning realization of capital gains or losses.

Corporate Reorganizations and the Realization Doctrine

Even the realization doctrine, as applied by the court, led to the creation of income tax liabilities sooner, in many instances, than Congress deemed wise or appropriate. These instances occurred mainly in connection with corporate mergers, consolidations, recapitalizations, and reorganizations. The stockholders and bondholders of corporations participating in such readjustments commonly received new securities in exchange for their old ones. Prior to the Revenue Act of 1921 such exchanges were in some cases held to be the equivalent of sales, requiring the participants to report as a realized gain or loss any difference in value between the securities received and the cost or other basis of the securities surrendered.

Two objections were forcefully voiced against recognizing gain or loss for tax purposes on exchanges of this character. First, many corporate readjustments that involve the issuance of new securities for old do not interrupt the continuity of the taxpayers' investment or alter its essential character. The investor receives no money; the new securities merely replace the old ones. To require him to pay a tax on the paper profit imputedly realized in such a transaction may force him to sell a portion of the securities when he would prefer to retain an undiminished interest in the enterprise, and may force him to make the sale at an unfavorable time as well. The investor is in essentially the same position as one with an unrealized gain.

Second, when all or many such exchanges are treated as occasioning a realization of gain or loss, corporate officials and securities owners hold back from making various normal and useful readjustments in capital structures and intercorporate relations for fear of incurring immediate tax liabilities. It was contended during the Congressional hearings on the Revenue Act of 1921 that many corporate reorganizations that had been made desirable by the depression of 1920-21 were being impeded by this fear.[47]

In response to these considerations, Congress specified in the Revenue Act of 1921 that no gain or loss shall be recognized in connection with certain classes of exchanges even if the property received in exchange had a realizable market value. The aim was not permanently to exclude these gains and losses from the income tax, but to postpone recognition of them until a more appropriate occasion, i.e., sale. Wide openings for tax avoidance through the use of the so-called reorganization provisions were soon discovered to exist, however. Successive attempts to close the loopholes were made in the Revenue Acts of 1923, 1924, 1926, 1928, 1932, 1934, and, in minor ways, since. Under present law, which in the main embodies the elaborately contrived revisions enacted in 1934, six kinds of reorganizations are defined, in connection with which exchanges of property may take place without the recognition of gain or loss:

[47] See *Hearings on Revenue Revision*, Ways and Means Committee, 66th Cong., 3d sess; *Report of the Ways and Means Committee*, 67th Cong., 1st sess. (House Report 350); J. S. Seidman, *Legislative History of Federal Income Tax Laws*, p. 790.

1. A statutory merger or consolidation by which one corporation absorbs another or two or more corporations unite to form a new one.
2. The acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per cent of the voting stock and at least 80 per cent of all other classes of stock of another corporation.
3. The acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation.
4. A transfer by a corporation of all or a part of its assets to another corporation if, immediately after the transfer, the transferor or its shareholders or both are in control of the corporation to which the assets are transferred.
5. A recapitalization.
6. A mere change in identity, form or place of organization.

In addition, the law specifies:

No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of stock or securities received by each is substantially in proportion to his interest in the property prior to the exchange. . . .[48]

In seeking to confine the taxpayers' advantage from the nonrecognition provisions to postponement of, rather than exemption from, tax liability, the law requires him to measure the gain on any subsequent sale of the property he receives by a basis determined by the original cost of the property given for it, less any money received and plus any gain recognized.[49] Where a corporation issues its own stock as a consideration for property, the basis of the property acquired is the cost to the transferor, increased by the amount of any gain or decreased by the amount of any loss recognized by the latter in the transfer.[50] In these ways, the law endeavors to take account eventually of the appreciation or depreciation occurring up to the time a piece of property is transferred in a tax-free exchange.

Specific as the reorganization provisions appear to have become, they still leave considerable room for judicial interpretation. The question of the distinction between an outright sale and a reorganization has arisen repeatedly. In *Pinellas Ice and Coal Storage Company* v. *Commissioner*, the assets of two companies were transferred to another company for cash and short-term notes. The court held that this was not a reorganization, observing that to rule otherwise " would make evasion of taxation very easy." [51] In a series of decisions the court appears to have arrived at the broad rule that, as respects the consideration received in what presumes to be a tax-free reorganization rather than a sale, " common and preferred stock in sufficient proportion passes the test, while bonds do not." [52] The court has indicated that a continuity of proprietary interest in the reorganized company must be maintained

[48] *Internal Revenue Code*, sec. 112 (b) (5). Control is defined as ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock.

[49] *Internal Revenue Code*, sec. 113 (a) (6).

[50] *Internal Revenue Code*, sec. 113 (a) (7).

[51] 287 U. S. 469 (1933).

[52] Randolph E. Paul, *Studies in Federal Taxation*, 3d Series (Cambridge: Harvard University Press, 1940), p. 104.

by the shareholders in the predecessor company.[53] It has excluded various tax-avoidance schemes by requiring that the exchange of assets by one corporation with another in a tax-free reorganization must have a business purpose, not merely the purpose of avoiding taxes.[54] It has held that the earnings of the predecessor companies participating in a tax-free reorganization are also the earnings of the successor, and therefore constitute taxable dividends when distributed to the shareholders. The court thus prevented the use of reorganizations for the purpose of effecting tax-free distributions of accumulated corporate earnings. In all these respects the court has generally insisted that the spirit as well as the letter of the law be observed. To be tax-free, the exchanges must be "required by business exigencies" and they must "effect only a readjustment of continuing interest in property under modified corporate forms." [55] The consequence has been a narrowing of the opportunities for tax-avoidance. Taking its language in part from the decisions of the court, Congress amended the Internal Revenue Code in 1943 to provide that persons who obtained control of a corporation on or after October 8, 1940, and corporations that acquired the property of others the basis of which is also transferred, for the principal purpose of evading or avoiding income or excess profit taxes, are denied the deductions, credits or other allowances requisite to attainment of that end.[56]

[53] *Ibid.*, pp. 104-21, and Magill, *op. cit.*, pp. 153-62.

[54] *Gregory* v. *Helvering*, 293 U. S. 465 (1935); and *Lea* v. *Commissioner*, 96 F. (2nd) 55 (1938).

[55] Treas. Reg. 103, sec. 19, 112 (g)-1.

[56] Sec. 129.

Wide Latitude Possessed by Congress

In the light of the judicial decisions reviewed in the foregoing, Congress possesses wide constitutional powers respecting the tax treatment of capital gains and losses. It may tax realized capital gains in full as ordinary income, as it did under the income tax laws of 1913 through 1920. It may subject them to lower rates of tax or exempt varying proportions, as it has done in one fashion or another at different times since 1921. There is no reason to believe that it lacks the power to exempt them altogether from ordinary income taxes. Its power to allow or to disallow deductions for losses to any extent it deems desirable is beyond dispute. Only the power to tax unrealized gains has been denied by the Supreme Court. Even here, there is a strong possibility that the court might uphold at least the optional inventorying of securities and other capital assets on the basis of market value, if Congress saw fit to extend this privilege. Dealers in securities are at present permitted to inventory their holdings on the basis of market value if they choose. (Ordinary business concerns are usually required to account for their inventories on the basis of cost, or the lower of cost or market value, or on a "last-in first-out" basis.) [57] If the law so permitted, the investor who elected to inventory his securities on a market value basis would, in effect, acquire the right to deductions for unrealized capital losses in exchange for agreeing to subject his unrealized profits to taxation. In the opinion of Professor Magill, the decision of the Supreme Court in *Helvering* v. *Independent Life Insurance Company* indicates that an

[57] Treas. Reg. 111, sec. 29.22, (c)-5 and (c)-2; sec. 22 (d).

optional provision of this kind would be valid.[58]

That the court would uphold the *compulsory* inventorying of capital assets on a market value basis as a part of a general method of accounting and reporting for income tax purposes is far more doubtful, though not inconceivable. Although the issue is by no means clear, Professor Magill has pointed to several recent decisions indicating that such a plan might be upheld.[59] Whether Congress could constitutionally treat as income unrealized capital gains embodied in property transferred by *inter vivos* gift or at death is a major unsettled question.

Within these relatively moderate constitutional barriers Congressional policy is free to respond, in framing the tax treatment of capital gains and losses, to considerations of equity, economic effects, and administrative convenience.

[58] 292 U. S. 371, 54 Sup. Ct. 758 (1934); Magill, *op. cit.*, p. 121.

[59] Magill, *op. cit.*, pp. 119-20. The cases cited are *Helvering v. Bruun*, 309 U. S. 461, 60 Sup. Ct. 631 (1940); *Helvering v. Midland Mutual Life Insurance Company*, 300 U. S. 216, 57 Sup. Ct. 423 (1937).

PROSPECTIVE POPULATION AND INCOME GROWTH AND FISCAL POLICY

JOSEPH J. SPENGLER *

"What exceeds the right proportion is very troublesome."
—Dio Chrysostom, in Seventeenth Discourse

DEFECTS in public and private policy arise in part from misconceptions regarding the expansion coefficient of the economy for which the policy is intended. The post-1939 upsurge of the American economy, together with injudicious interpretation of this upsurge, has given the impression that the American economy will expand more rapidly than it appears capable of. Because of this unwarranted impression and the expanding demands of ever more effectively organized pressure groups, the American economy is being called upon to support measures beyond its capacity. A principal effect of this lack of proportion, if it persists and affects policy, will be a secular upward movement of prices.

In the present paper the significance of this disproportion for fiscal policy is considered. Sections I and II, which deal with the prospective growth of national income and public expenditure, call attention to the constraints to which the growth of national income will be subject, and indicate that its progress will almost certainly lag behind that of public expenditure. Sections III and IV treat of the inflationary and the growth-retarding effects of this disproportion in an institutional situation such as now prevails. All estimates are for calendar years unless otherwise specified.

I. THE FACTS

We present the facts relating to population and income growth under three heads: (1) the past and the prospective growth of population P; (2) the past and the prospective growth of real income per capita y; (3) the past and the prospective growth of national real income Py $(=Y)$. The period with which we are principally concerned, 1950-2000, will be contrasted occasionally with the periods 1870-1920 and 1800-50.

Growth of Population

Despite the recent upsurge in the rate of growth of the American population, it will grow much less rapidly in the future than in the past, and it will probably have almost attained a stationary condition by the close of the present century. Its compound annual rate of growth approximated 3 per cent in and before 1800-50; it moved downward in 1870-1920, approximating 2 per cent for the whole period; and in 1920-49, a period marked by great economic variation, it fluctuated, approximating ⅔ per cent for the whole period. While

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TABLE 1

INDICES OF GROWTH OF POPULATION AND NATIONAL INCOME

Year	Index of Population		Index of National Income, Given Designated Yearly Rate of Increase in Income Per Capita							
	Small $=S$	Large $=L$	1 Per Cent		1.5 Per Cent		2 Per Cent		2.5 Per Cent	
			Small	Large	Small	Large	Small	Large	Small	Large
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1950	100.0	100	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1960	107.1	107	118.3	118.2	124.3	124.2	130.6	130.4	137.1	137.0
1970	113.0	120	137.9	146.4	152.2	161.0	167.9	178.3	185.2	196.6
1980	117.8	130	158.8	175.2	184.1	203.2	213.4	235.5	247.1	272.7
1990	121.5	137	180.9	204.0	200.3	248.5	268.3	302.5	326.2	367.9
2000	124.5	142	204.8	233.5	262.1	298.9	335.1	382.2	427.9	488.1

Sources: See note 1 respecting columns 2-3 and text respecting columns 4-11.

it could conceivably approximate ⅔ per cent in 1950-2000, it most probably will continue to fall, along the lines indicated by the logistic theory, and approximate not more than ½ per cent a year for the whole period.

The course of growth that now seems most probable is one that will carry the population total—about 151.7 millions in 1950—along the upper branch of a logistic curve to 186-89 millions by 2000 and to an eventual maximum of around 200 millions. It is improbable that at the outside the American population will exceed 210-15 millions in 2000 or attain a maximum in excess of 220 millions. These figures are somewhat higher than the maximum of 165 millions forecast a few years ago for 1990; and they suppose some growth even in the next century. In columns 2-3 of Table 1 the logistic and the larger growth projections are reported in index form. These indices yield populations of 189 and 215 millions, respectively, as of 2000, given a 1950 population of 151.7 millions. If, as is possible, the comparatively high recent growth rate is offset by a dispersed compensatory adjustment in the future, the index values will be slightly lower, and the figures for 2000 will be 3-5 millions lower.[1]

[1] Increase per decade ranged between 32.7 and 36.4 per cent in 1800-50. It moved as follows in the decades ending in designated years: 1870, 26.6; 1880, 26; 1890, 25.5; 1900, 20.7; 1910, 21; 1920, 14.9; 1930, 16.1; 1940, 7.2. It will approximate 15 per cent in 1940-50, if the mid-1950 population approximates 151.7 millions.

During the five years succeeding mid-1940 the population increased 7.6 millions, or 5.8 per cent; the corresponding figures for the succeeding quinquennium will approximate 12.1 and 8.7. During the six years following July 1, 1940, the annual excess of births over deaths approximated 1,418 thousands; and annual net immigration, 126 thousands. During the three years ending July 1, 1949, the corresponding figures were 2,358 and 302 thousands. This advance in the annual increment of natural increase is attributable to a great advance in the annual number of first to third order births, an advance partly imputable to a marked increase in the number of families. In 1940-49 while the population was increasing 12.9 per cent, the number of families rose about 20.5 per cent, and the relative number of females 14 and over, married, and with spouse present, rose from 56.4 to 63.1 per cent. While there is little evidence as yet that births beyond the second have increased significantly enough to indicate a marked change in the underlying culture and a continuation of the current high rate of natural in-

In the future, unlike in the past, the labor force, or population of working age, will grow at approximately the same rate as the total population. For purposes of discussion we shall represent this group by the number aged 20-64 years. In 1800-50 this number grew at an annual rate slightly in excess of 3 per cent, and in 1870-1920 at a rate of about 2¼ per cent. Whelpton's maximum estimate indicates a 24.3 per cent increase in the number aged 20-64 in 1950-75; this contrasts with an increase of 25.1 per cent in the population total. His minimum estimate indicates increases of 12.3 and 15.5 per cent, respectively, in the total population and the number aged 20-64 in 1950-2000.[2]

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crease, it is probable that the increase in the relative number of females, married and exposed to pregnancy, will elevate the future rate of natural increase somewhat above the level implied by forecasts made in the late 1930's and the early 1940's. On this question see P. K. Whelpton, "The Meaning of the 1947 Baby Boom," Vital Statistics-Special Reports, XXXIII, No. 1 (October 7, 1948), Federal Security Agency, Washington; W. S. Thompson, "The Demographic Revolution in the United States," *Annals* of the American Academy of Political and Social Science, CCLXII (1949), 62 ff.; and a forthcoming paper by J. S. Davis "Our Amazing Population Upsurge." Estimates for 1940 to date are given in Current Population Reports of the Bureau of the Census, Series P-25, Nos. 27 and 30; estimates for 1950-55 are given in *ibid.*, No. 18. Figures for 1940 and earlier, together with forecasts, are given in W. S. Thompson, *Population Trends in the United States* (New York: McGraw-Hill Book Co., 1933), pp. 1, 109, and P. K. Whelpton *et al.*, *Forecasts of the Population of the United States, 1945-1975* (Washington: U. S. Bureau of the Census, 1947), pp. 39, 49, 109.

The logistic curve we employ suggests the following populations (in millions), the figures in parentheses representing upward adjustments to allow for an actual population of 151.7 millions in 1950: 1950, 149.3 (151.7); 1960, 159.9 (162.5); 1970, 168.7 (171.4); 1980, 175.8 (178.7); 1990, 181.5 (184.4); 2000, 185.8 (188.8); and a maximum of about 199 (202). The index values in column 2 of Table 1 are based upon these figures. On the compound assumption of high natality (15 million births in 1945-50), low mortality, and a net immigration of 200,000 per year, Whelpton arrived at these maximum estimates (in millions): 1950, 148; 1960, 162; 1970, 177.1; 1975, 185.1. Continuation of this series, but with falling incremental rates, yields: 1980, 192; 1990, 203; 2000, 210; and a maximum of about 214. This arrangement assumes a slight post-1950 downward adjustment to offset the fact that the actual 1950 figures will approximate 151.7 instead of 148 millions. If this compensatory adjustment is not made, the estimate for 2000 becomes about 215 and the maximum about 219. The index values given in column 3 of Table 1 assume no compensatory downward adjustment. Given a constant 3 million births per year and an eventual discontinuance of net immigration, the population will approach a maximum in the neighborhood of 210 millions. (Births per year averaged 2.25 millions in 1936-40; 2.76 in 1941-45; 3.52 in 1946-48). Concerning the logistic theory (which appears to reflect transitory influences more accurately than does the theory underlying most more empirical forecasts) and estimates based thereon, see R. Pearl, *Biology of Population Growth* (New York: Alfred A. Knopf, 1925), pp. 13, 219; papers by R. Pearl and L. J. Reed in *Science*, LXXII (1930), 399-401, XCII (1940), 486-88; H. S. Will, "On a General Solution for the Parameters of any Function with Application to the Theory of Organic Growth," *Annals* of Mathematical Statistics, VII (1936), 165 ff.; H. Hotelling, "Differential Equations Subject to Error and Population Estimates," *Journal of the American Statistical Association*, XII (1927), 283-314. I have used Will's logistic forecast.

[2] The number aged 20-64 increased as follows in the decades ending in the designated years: 1870, 30.1 per cent; 1880, 29; 1890, 29.5; 1900, 24; 1910, 26.3; 1920, 18.9; 1930, 18.8; 1940, 14. Whelpton's maximum forecast indicates increases of 7, 11.2, and 3.7 per cent in 1950-60, 1960-70, and 1970-75. Corresponding increases for the total population are 9.5, 9.3, and 4.6. For the whole period 1950-75 increases of 25.1 and 24.3, respectively, are indicated for the total population and the number aged 20-64. To allow for the discrepancy in 1960 I have set at 107 the population index in column 3 of Table 1 for 1960; for other years we get approximately the same index values for the total population and that aged 20-64. The index values in column 2 are based on the assumption that the number aged 20-64 increases at the same rate as the total population.

Employability, regularity of employment, and economic productivity while working vary with age even within the age-group 20-64. Nonetheless, the movement of the number within this age-group pro-

Growth of Per Capita Real Income

The past movement of per capita real income y, one of the two determinants of national income Y $(= Py)$, tells us something respecting the limits within which it may move in the future. It grew much more rapidly in 1870-1920 than in 1800-50—2 per cent or slightly more per year as compared with $\frac{1}{4}$ per cent; thereafter it advanced at a lower rate.[3]

Martin's study reveals at least three things: (a) the rate of growth of per capita *real* income varies appreciably, periods of marked growth being succeeded by periods of little or no growth, and conversely; (b) an improvement occurred in the rate after 1870 and a decline in the present century; (c) if the future repeats the past, the annual rate will fall short of rather than exceed 2 per cent. Per capita income declined in 1799-1829; rose in 1829-59; fell in 1859-69; advanced (though at a decreasing rate after 1909) in 1869-1929; and declined precipitately in 1929-33, not to regain the 1929 level until 1940. While per capita income grew only slightly more than $\frac{1}{2}$ per cent per year in 1799-1859, it did advance 2 per cent per year in 1829-59. Its highest sustained annual rate of growth, $2\frac{1}{4}$ per cent, in 1869-1909, was succeeded by a 1 per cent rate in 1909-41, which reduced the comparable 1869-1941 rate slightly below $1\frac{3}{4}$. Rates for 1869-1919 and 1869-1929 were just under 2 and just over $1\frac{3}{4}$ per cent, respectively. The long-period rates are somewhat lower, those for 1829-1929 and 1829-1941 being just over $1\frac{3}{8}$ per cent and those for 1799-1929 and 1799-1941 being slightly over $\frac{7}{8}$.

Kuznets's estimates indicate a slightly higher rate of growth in per capita real income after the Civil War than do Martin's. The highest rates yielded by Kuznets's series are just under $2\frac{1}{2}$ per cent in the period 1869-78 to 1904-13 and just over $2\frac{1}{2}$ per cent in 1919-29. For the whole period, 1869-78 to 1941-43, a rate of 2 per cent obtained, the lowness of the 1929 to 1941-43 level (just over $1\frac{1}{8}$) serving to offset in part the nearly $2\frac{1}{4}$ per cent rate which prevailed in 1869-78 to 1929.[4] Dewhurst's

vides almost as satisfactory an index of a population's productive power as does the movement of a more refined measure that takes age-connected variations into account. See my "The Economic Effects of Changes in Age Composition," in *Birthdays Don't Count*, issued by the New York State Joint Legislative Committee on Problems of the Aging (Newburgh, New York, 1948).

[3] Our income figures are taken or computed from R. F. Martin, *National Income in the United States, 1799-1939* (New York, 1939), published by the National Industrial Conference Board which has carried them through 1941 in its *The Economic Almanac*; S. Kuznets, *National Product Since 1869* (New York: National Bureau of Economic Research, 1946), esp. pp. 52-56, 106-07, 119-20, and 85 ff. for comparison with Martin's estimates; C. S. Shoup, *Principles of National Income Analysis* (New York: Houghton Mifflin Co., 1947), pp. 81-83, and generally for examination of differences between Kuznets's and Department of Commerce estimates; *Survey of Current Business*, July, 1947, ff.; Colin Clark, *Conditions of Economic Progress* (London, 1940), pp. 148 ff.; J. F. Dewhurst *et al.*, *America's Needs and Resources* (New York: Twentieth Century Fund, 1947), chaps. 2, 20, and pp. 695-97. On differences in concepts see R. Ruggles, *Introduction to National Income Analysis* (New York: McGraw-Hill Book Co., 1949). Martin's agricultural estimates are criticized by N. J. Silberling who also presents a business index running back to 1700. See his *The Dynamics of Business* (New York: McGraw-Hill Book Co., 1943), pp. 48 ff., 133, 140, 516, 661, 702. The growth rates are the nearest approximations obtainable with Glover's tables.

[4] I have used Kuznets's net national product figures (treated as "national income" by Shoup, *op. cit.*, pp. 80 ff.) which, however, usually exhibit virtually the same growth rates as do his gross national product figures. Throughout 1869-

study, based in part upon Kuznets's data, indicates per capita growth rates of just over 1¾ and just over 2 per cent in 1909-44 and 1919-44.

The Department of Commerce estimates of real national income indicate a higher post-1919 rate of growth in per capita income than do Kuznets's: 1919-44, 3; 1929-44, over 3½; 1919-29, 2.[5] Estimates in current dollars, deflated by the consumers' price index, yield rates of 2½, 2¼, and 2¾ for 1919-48, 1929-48, and 1919-29. Stigler's estimates of output per worker in six industries indicate annual growth rates of just over 2 and 2¾ per cent, respectively, in 1899-1939 and 1919-39.[6]

In 1939-48 per capita *real* income grew about 5.5 per cent per year. Much of this increase is attributable, however, to the increase in the relative amount of employment, the *employed* civilian labor force increasing approximately 3 per cent per year, or more than twice as fast as the *total* labor force (just under 1⅜). The corresponding compound annual growth rates for real earnings in manufacturing were: average gross weekly, just under 3; hourly, just under 3¼.

Both the 1939-48 growth rates and those suggested by the Department of Commerce estimates appear to be too high to reflect long-run per capita growth. They are dominated by the post-1939 situation and make too little allowance for the operation of retardative factors. In the light of Kuznets's studies it seems that a per capita income growth rate of about 2 per cent per year is more in keeping with economic reality.

Will per capita income continue to increase about 2 per cent per year? Our data suggest no clear-cut answer. Consideration of the compound interest principle indicates, however, that even a 2 per cent growth rate can persist only for a limited time.[7] The tendency of income data to describe a logistic curve also suggests a declining rate of growth.[8] Moreover, a number of circumstances will operate, unless compensated by sufficient technological improvements, to reduce the annual rate of growth in per capita income: e. g., a further diminution in the number of hours worked per year; [9] reduction in retire-

78-1941 the per capita flow of goods to consumers grew at a rate always somewhat over 2 and slightly exceeding 2¼ per cent for the whole period.

[5] These are based on the old series; the new series, first published in 1947, would yield higher growth rates as it steps up the 1929 figure 4.1 per cent and the 1944, 21.6 per cent. No data are yet available for the period before 1929. On the differences see Shoup, *op. cit.*, esp. pp. 371 ff.

[6] G. J. Stigler, *Trends in Output and Employment* (New York: National Bureau of Economic Research, 1947), chap. 3 and p. 34. The six industries covered embraced half or more of the gainfully employed. Output per man-hour increased just over 2¾ per cent in 1899-1939. For 1850-1940 Dewhurst (*op. cit.*, p. 23) reports a rate of 1.7 per cent per year. A slightly higher rate is indicated for 1870-1940.

[7] E. g., see C. J. Bullock's study, suggested by Pareto's and Gini's inquiries, "Public Finance and the Compound-Interest Principle," *Quarterly Journal of Economics*, LII (1938), 641-58.

[8] Cf. H. Hart, "Logistic Social Trends," *American Journal of Sociology*, L (1945), 339, 341-42, 345. Clark believes he has found similar evidence. E. g., see his *National Income and Outlay* (London: Macmillan and Co., 1937), p. 271. Of course, if underlying conditions change, a new logistic may issue from an old one. An annual growth rate of slightly over 1¾ per cent is indicated for per capita real income by an exponential trend fitted by Hart (in an unpublished paper) to "high-year" values as of 1870-1929.

[9] To illustrate, suppose (in line with a recent observation made by S. H. Slichter, *Fortune*, Sep-

ment age; [10] the tendency of consumers, as per capita income rises, to expend a larger fraction of this income upon goods and services whose production appears relatively less amenable to mechanization and mass-production economies and therefore less susceptible of reduction in labor and other inputs per unit of output; exhaustion of the income-increasing effects of changes in age composition; shrinkage in the volume of movement of population out of agriculture and into industry and commerce; and supersession of extensive by intensive growth.

In view of the levels of per capita growth experienced in America in the past and confirmed by experience abroad [11] it is improbable that per capita income will grow much faster than 2 per cent year, and it is quite possible that the realized rate will be less.

Growth of Real National Income

In the future *real* national income will grow only about half as fast (if that much) as in the past. For, in consequence of the gradual cessation of the growth of population (P), the increase of national income (Py) will be dominated by that of per capita income (y). National real income grew more rapidly after 1870 than before 1860, according to Martin's estimates: 1799-1859, over 3½ per cent per year; 1869-1929, over 3¾; 1869-1941, 3½. The highest sustained rates were: 1829-59, over 5; 1869-1909, 4½. A growth rate of 3¼ to 3½ per cent per year characterized the periods 1799-1929 and 1799-1941. Kuznets's estimates yield a growth rate of over 4½ for the period 1869-78 to 1904-13 and 4¼ for 1869-78 to 1919. In consequence of rates of under 4 per cent in 1919-29 and only 1¾ in 1929-41, the rate for the whole period 1869-78-1941-43 is below 4, approximating 3¾. Dewhurst's data in-

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tember, 1949, p. 110) that output per man-hour continues to rise by 2 per cent per year, but that by 1980 the number of hours worked per year is reduced by one-fourth; then the growth rate becomes only 1 per cent. (The standard number of hours worked per week outside agriculture declined from 54.6 to 44 in 1910-40 and, Dewhurst estimates [*op. cit.*, p. 695] will decline to 38 by 1960. It is questionable whether hours will decline as much as one-fourth in 1950-80.)

[10] Given the age composition of around 1970, fixing the retirement age at 60 would reduce national income about one-tenth below what it otherwise would be. From the standpoint of the individual, reduction of the retirement age from 65 to 60 means an extension, on the average, of his post-retirement lifetime by something like 25 per cent or more, and a corresponding augmentation of the amount that he or others must provide for his support.

[11] E. D. Domar ("The 'Burden of the Debt' and the National Income," *American Economic Review*, XXXIV [1944], 826) reports the following percentage rates of increase in real income per capita, by country: Australia, 1902-29, 1.1; Canada, 1919-40, 1; Germany, 1891-1913, ½; Japan, 1919-36, 2.5; New Zealand, 1926-40, 2; Sweden, 1913-30, 1.8. Clark's estimates (*op. cit.*, pp. 148 ff.) indicate that real income produced per worker (based on a 48 hour week) grew annually about as follows: Canada, 1903-38, 1⅜; New Zealand, 1902-37, 1⅞; Australia, 1902-37, 1½; Great Britain, 1865-1937, 1¼; Germany, 1854-1937, 1-5/16; Sweden, 1865-1936, 2⅜; Denmark, 1913-30, 1⅜; Norway, 1891-1937, 2½; Holland, 1913-29, 13/16; Switzerland, 1890-1929, 2; Russia, 1860-1937, 15/16; France, 1845-1928, 1⅝; Italy, 1893-1929, 2⅛; Japan, 1887-1935, 3¼. I have selected as terminal dates years when income was high. In the period covered, per capita income increased slightly faster than per worker income since the relative number of workers increased. Of the fourteen cases reported by Clark only four indicate rates of growth in excess of 2 per cent, and in these four cases per worker income was comparatively low in the base year. A more recent study of changes in product per man-hour yields growth rates similar to those just presented. See Clark, "Levels of Real National Product per Man-Hour," *Review of Economic Progress*, I (1949), 1 ff.

dicate annual growth rates of just over 3 and about 3¼ per cent in 1909-44 and 1919-44. According to the old Department of Commerce series real national income increased just over 4 per cent per year in 1919-44 and over 4½ in 1929-44. Current estimates, deflated by the consumer price index, yield a rate of just over 3 for 1919-48 and 1929-48 and one of 6¾ for 1939-48.

Table 1 is designed to indicate the probable course of real national income in 1950-2000. Prospective population growth is reported in index form in columns 2-3, the former of which represents the logistic pattern and the latter Whelpton's maximum estimate adjusted downward for the post-1975 period. The former and smaller estimate we denote with S; the latter and larger, with *L*. Probable future national income is reported in columns 4-11. Column 4 is based on the supposition that per capita income grows 1 per cent per year while population progresses as in column 2; column 5 is based on the same income growth supposition, but now combined with population growth as reported in column 3. Columns 6-11 are arrived at in the same manner, except that different per capita growth rates are utilized. These columns indicate a much smaller growth in national income than was experienced in 1870-1920 when, on the assumption of a 4 per cent per year increase in national income, the comparable sequence generated approximated the following: 100, 148, 219, 324, 480, 711. Table 1 suggests that, if we set the 1950 national income at $220 billions, national income will lie between $451 and $1,074 billions in 2000, with a most probable range of $451-577 billions.[12]

II. THE GROWTH OF PUBLIC EXPENDITURE: NATIONAL-INCOME RATIO

Public expenditure did not begin to pull sharply away from national income until after 1913. Federal expenditure merely kept pace with national income before 1860 and lagged behind it in 1870-1913. Much the same relationship characterized state and local expenditure which, however, in time of peace, then grew more rapidly than Federal expenditure. During the quarter-century succeeding 1890 public expenditure approximated 7.5 to 9 per cent of national income, and tax revenues, a slightly smaller fraction. In 1929 the comparable fractions stood at 14.3 and 12.3, both Federal and state and local expenditure having increased much more

[12] Various national income growth rates have been assumed. A. H. Hansen and H. Perloff (*State and Local Finance in the National Economy* [New York: W. W. Norton and Co., 1944], pp. 240, 288) assume a 3 per cent rate; but Hansen, in reply to a criticism by N. W. Chamberlain, adopts a 2-3 per cent rate (*American Economic Review*, XXXV, 410) as does Domar (*ibid.*, p. 415). S. E. Harris (*National Debt and the New Economics* [New York: McGraw-Hill Book Co., 1947], p. 172) appears to think that national income will grow as in the past. G. Crowther (*Yale Review*, XXXIV [1945], 218) has assumed a per capita rate of 1½ per cent. S. H. Slichter appears to assume a rate little if any in excess of 2 per cent (cf. his most recent discussion in *Fortune*, September, 1949, p. 110). H. G. Moulton, while eschewing prophecy, cites increases in output per man-hour of 1.9-2.5 per cent (*Controlling Factors in Economic Development* [Washington: Brookings Institution], pp. 380-81). In their *Annual Economic Review* (Washington, January, 1949, p. 52), the President's Council of Economic Advisers anticipates "for the next few years" an annual increase of "about 3 per cent," but does not project a rate into a defined future. Dewhurst *et al.* (*op. cit.*, p. 23) estimate the 1950-60 increase at about 15 per cent, or about 1⅜ per cent per year. The AFL Executive Council apparently considers a rate of 2.3 per cent per year per capita to be "close to normal" (see J. A. Loftus in *New York Times*, October 3, 1949).

rapidly than national income in the interval.[13]

The period since 1929 marks a new epoch in American financial history. It has witnessed the ascendance (in amount since 1941) of Federal over state and local expenditure, a vast increase in outlays connected with war and defense, the assumption by the Federal Government of new and expensive functions at home and in the international sphere, and the organization of a number of powerful pressure groups bent upon obtaining free income from the government.

The major changes taking place in 1929-39 and 1929-48 are reported in Table 2. Net tax receipts increased much faster than income, the ratio of tax receipts and social security contributions to national income rising from

[13] Public expenditure, expressed as a percentage of national income, was: 1890, 8.5; 1902, 8.8; 1913, 7.6; 1914, 9.1; 1916, 8.5; 1929, 14.3. The comparable fraction for tax revenues was: 1890, 8.3; 1902, 8.6; 1913, 7.2; 1916, 6.8; 1929, 12.3. These percentages are approximately comparable. I have used Martin's estimates of national income, interpolating for 1890 and 1902. The 1914-16 and 1929 figures do not include social security taxes or expenditures except for administration, but these omissions are insignificant for the years in question. Expenditure and tax data for 1890, 1902, and 1913 are given in *Historical Review of State and Local Government Finances* (State and Local Government Special Studies Number 25) (Washington: U. S. Bureau of the Census, June, 1948), and in *Historical Statistics of the United States, 1789-1945* (Washington: Bureau of Census, 1949), pp. 296, 299, 314. Those for 1914, 1916, and 1929 are from National Industrial Conference Board, *The Economic Almanac for 1948*, pp. 277-78. The figures for 1929-48, used in subsequent paragraphs, are from the *Survey of Current Business*, July numbers, 1947 ff., and the *Annual Report* of the Secretary of the Treasury, unless otherwise indicated. Accordingly, since income estimates of the Department of Commerce are higher than Martin's, the resulting percentages are not strictly comparable. Detailed breakdowns for 1913, 1932, and 1941, as well as for 1950 and 1960, are given in Dewhurst, *op. cit.*, chap. 20.

TABLE 2

INCOME AND FISCAL CHANGES, 1929-48
(CURRENT DOLLARS)

Category	Per Cent Change in Interval 1929-39	Per Cent Change in Interval 1929-48
1. National income ($=Y$)	−17	159
2. Gross national product ($=$GNP)	−12	153
3. Net tax receipts (a)* ($=Ta$)	24	438
4. Net tax receipts (b)* ($=Tb$)	42	468
5. Total governmental expenditures ($=G$)	69	407
5a. Governmental income originating payments †	75	309
5b. Governmental purchases from business and abroad	32	360
5c. Other governmental payments ‡	140	759
6. $Ta \div Y$	47	103
7. $Tb \div Y$	67	118
8. $G \div Y$	104	96
9. Governmental contribution to GNP ÷ GNP	74	71

Source: Based upon *Survey of Current Business*.

* Social security contributions excluded from (a) and included in (b).

† Includes wages, salaries, social insurance contributions, and other labor income.

‡ Includes transfer payments, net interest, and net subsidy.

11.9 per cent in 1929 through 20.1 in 1939 to 25.9 in 1948. Corresponding percentages, with social security contributions excluded, are: 11.6; 17.1; 23.5. Governmental expenditures increased much faster than national income in 1929-39 and somewhat less fast in 1939-48, inasmuch as 1939 was marked by a large governmental deficit and 1948 by a large surplus. The ratio of governmental expenditure to national income rose from 11.7 per cent in 1929 to 23.9 in 1939 and then declined slightly to 22.9 in 1948.[14] The percentage changes in these ratios are given on lines 6-8 in Table 2.

[14] These (as well as other) percentages are de-

Lines 5-5c and 9 indicate the changes that have taken place in the composition of governmental expenditure. The items reported on lines 5a and 5b have lagged behind that reported on line 5c and the total reported on line 5. In 1929 the contribution of government to gross national product (compensation of employees [line 5a] and purchases from business and abroad [line 5b]) comprised 8.2 per cent of the GNP and 82.9 per cent of all governmental expenditure. In 1939 and 1948 the corresponding figures were 14.3 and 75.7 and 14.0 and 71. Meanwhile transfer, interest, and net subsidy payments rose from 17.1 and 2.1 per cent of governmental expenditure and national income, respectively, in 1929 through 24.3 and 5.8 in 1939 to 29 and 6.6 in 1948.[15] This change in composition will continue in the future, since it is upon the augmentation of transfer payments that free-income-seeking pressure groups are concentrating.

The determinants of public expenditure being what they are, there does not appear to be available for its extrapolation into the future so rational a basis as exists for the projection of past population and income trends. We might, for example, suppose that the *ratio* of net tax receipts (including social security contributions) to national income, or that of governmental expenditure to national income, will progress in the future as in the past. Thus the former *ratio* increased at something like the following compound annual growth rates (in per cent): 1929-39, 5¼; 1929-48, over 4; 1902-29, over 1½; 1902-39, 2½; 1902-48, over 2½; 1890-1929, 1; 1890-1939, over 1¾; 1890-1948, under 2. The corresponding rates of growth in the *ratio* of governmental expenditure to national income are: 1929-39, under 7½; 1929-48, over 3½; 1902-29, over 2; 1902-39, 2⅞; 1902-48, 2¼; 1890-1929, under 1⅜; 1890-1939, 2⅛; 1890-1948, under 1¾. It would not be far wrong to say, in the light of these rates, that if the course traced in the future resembles at all closely that pursued in the past, the *ratio* of both governmental expenditure and tax receipts to national income will grow at an average rate of 1 to 2 per cent per year.

Suppose a yearly growth rate of 1 to 2 per cent in both the ratio of net tax receipts to national income and that of governmental expenditures to national income. Suppose also that we have a balanced budget in 1950 with both ratios at 25 per cent of national income (in 1948 the expenditure and tax-receipt ratios were, respectively, 22.9 and 25.9). Given a 1 per cent growth rate this ratio would attain the following percentages: 1960, 27.6; 1970, 30.5; 1980, 33.7; 1990, 37.2; 2000, 41.1. Given a 2 per cent growth rate, we get: 1960, 30.5; 1970, 37.2; 1980, 45.3; 1990, 55.2; 2000, 67.3. Dewhurst and his staff estimated the 1950 and 1960

rived from the Department of Commerce income and expenditure data reported in the *Survey of Current Business*, July, 1947 and 1949. If we add to state and local expenditures the total of Federal expenditures exclusive of debt retirement, these percentages become 12.5, 24.1, and 23.9.

[15] Net interest paid by government rose from $983 millions in 1929 to $4,443 millions in 1948. Subsidies exceeded current surplus of government enterprise in 1939 and 1948. Government transfer payments (i.e., social insurance, old age, retirement, pension, compensation, relief, and related payments) rose from $912 millions in 1929 to $10,508 millions (about half of them war-connected) in 1948.

ratios at 31.5 and 30.4, respectively, on the supposition that income would increase somewhat more rapidly than expenditure in 1950-60.

On the face of it these ratio growth rates seem reasonable, in the absence of institutional constraints which set upper limits to the ratio of governmental expenditures, or tax collections, to national income. For, as has already been indicated, the rate at which the real national income grows in the future will be appreciably lower than in the past; and, as will be suggested in this section, the efforts of pressure groups to secure free income from the government will be intensified as never before in our national history, with the almost inevitable result that the rate at which public expenditures grow will be as great as, if not greater than, in the past. We shall defer for the present the question whether institutional constraints tend to become operative.

Conjecture attends any current forecast of the future magnitude of many elements of public expenditure, of some because they are under the empire of irregular and therefore unpredictable circumstances and of others because they remain under the dominance of forces whose chronological pattern has not yet been uncovered. For convenience, however, we divide public expenditures into (1) those which are unlikely to increase more rapidly than the national income and (2) those which probably will increase more rapidly than national income. For like reason we shall use the 1947-50 expenditure-distribution pattern as a base, and assume internal order and international peace, together with the persistence of present international tension. Money, it is supposed, will retain its 1950 purchasing power, this being the base year in our calculations. Finally, we shall assume for our base year, calendar 1950, a national income of $220 billions, a balanced budget, and expenditures and net tax (and related) receipts aggregating $55 billions each. The national income growth rates assumed are those based upon 1 and 2 per cent per year increases in output per capita (see Table 1, columns 4-5 and 8-9).

Under the conditions given, it seems quite probable that about seven-tenths of public expenditure will, in the aggregate, grow at a rate not significantly different from that of the national income. About three-fifths will keep pace with national income: i. e., state and local expenditure (including debt interest); outlays upon national defense, international affairs, and related finance.[16] Another 10-12 per cent, comprising outlays for general (Federal) government (about 2 per cent) and interest on the national debt (about 10 per cent), it is assumed, will progress at a rate one-half that of national income.[17] Underlying our assumption

[16] In 1890-1913 state and local expenditures roughly kept pace with national income; in 1919-41, they increased about 1.7 as much; in 1929-48, 0.73 as fast. In 1948 they comprised 32 per cent of public expenditure. With international conditions as they are and give promise of being, it seems safe to assume that outlays upon national defense, international affairs, and related finance will keep pace with national income.

[17] For purposes of computation and comparison we shall base our estimates of future public expenditure upon four income progressions from Table 1: S_1 and L_1 from columns 4 and 5; S_2 and L_2 from columns 8 and 9. The letters signify small and large population growth rates; the subscripts indicate the rates (1 or 2 per cent per year) of increase in per capita income underlying the estimate of national income. The income progressions selected

respecting the future outlay for interest are two suppositions: (a) that the *average* debt-interest rate will not fall; (b) that periodic recourse to deficit financing, consequent upon recurring unemployment and inadequate taxation, will augment the national debt and the amount of interest, with the ratio of the latter to the national income varying inversely with the rate of growth of the national income.[18]

The behavior of the remaining components of public expenditure, comprising 25-30 per cent of the total in 1947-50 and falling into four categories (resource development; outlays upon agriculture and the farm population, veterans' benefits and services, and social welfare), will dominate the *growth* of public expenditure in the future. These, together with the determinants of their behavior, we shall now consider.

Diverse circumstances are operating separately and in combination to augment public outlay upon these elements. Most important of all is the fact that one or more powerful pressure groups (at least two of which unite economic and political power in a measure without precedent in American history) are working almost unremittingly to augment outlays upon one or more of the four categories. Twenty million eligible war veterans, generally well organized, give both real and suppositious support to measures designed to augment veterans' benefits. The farmers, organized, respected, constituting nearly one-fifth of the population, and holding the balance of political power in many states and districts, can always make their demands felt. Social security has the strong support of both wage earners and the aged, the former of which embrace over one-half the labor force and are united and disciplined as never before, and the latter

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almost certainly represent the outside limits within which national income will move in the next 50 years, barring cataclysmic change.

Starting with a $6.6 billions outlay in 1950 for debt interest and general government, we get with L_1 and L_2, respectively, the following outlays (in billions of dollars): 1960, 7.2 and 7.6; 1970, 8.1 and 9.2; 1980, 9.1 and 11.1; 1990, 10 and 13.2; 2000, 11 and 15.9. The corresponding S_1 and S_2 outlays (in billions of dollars) are: 1960, 7.2 and 7.6; 1970, 7.9 and 8.8; 1980, 8.5 and 10.3; 1990, 9.3 and 12.2; 2000, 10 and 14.4. Starting with a $33 billions outlay in 1950 for state and local expenditures, national defense, and international affairs and finance, we get with L_1 and L_2, respectively, the following outlays (in billions of dollars): 1960, 39 and 43; 1970, 48.3 and 58.8; 1980, 57.8 and 77.7; 1990, 67.3 and 99.8; 2000, 77.1 and 126.1. The corresponding S_1 and S_2 outlays (in billions of dollars) are: 1960, 39 and 43.1; 1970, 45.5 and 55.4; 1980, 52.4 and 70.4; 1990, 59.7 and 88.5; 2000, 67.6 and 110.6.

[18] On this relationship see Domar, *op. cit.*, pp. 798-823. In 1930-39 the national debt increased about 150 per cent and interest thereon about 90 per cent, while the *current* national income declined slightly. Prior to the 1930's the interest-bearing national debt, together with interest on it, increased greatly only in times of war, thereafter to decrease. (See B. U. Ratchford, "History of the Federal Debt in the United States," *American Economic Review* [*Proceedings*], XXXVII [1947], 131-41; also E. J. Hamilton, "Origin and Growth of the National Debt in Western Europe," *ibid.*, pp. 118-30). Since 1930 and the adoption of deficit-financing, domestic emergencies have also been the occasion of debt expansion. It is to be supposed, therefore, that the national debt-reduction (9 per cent) achieved in 1945-48 is transient, debt-increasing outweighing debt-decreasing forces. It is of interest to note that Thomas Jefferson, using the rate of population growth as the measure of the rate at which the nation's tax base was expanding, foresaw the day when the public debt would be paid off and internal taxes could be dispensed with. (See A. A. Lipscomb, ed., *The Writings of Thomas Jefferson* [Washington: Thomas Jefferson Memorial Association, 1903], III, 330-31; XIII, 365-67; also VI, 186, XIII, 38, XIV, 204.)

of which are rapidly growing in number and influence.[19] Finally, there are regional groups interested in resource development, and various smaller groups interested in one or more of these categories of expenditure. Of significance here is the fact that the pressure groups continually strive after monetary support from the government, both to augment their *real* " take " and to offset any " take "-depressing effects resulting from recurring inflation.

The demands of the pressure groups, whether or not compatible with approved economic criteria, receive expanding support from the secular change in " values " that is under way, and from the steady redistribution of political power to the " common man " and, more particularly, to his representatives and spokesmen. Illuminating, for example, are the arguments advanced in support of increased outlays for various components of " social welfare." Several of these arguments, while valid within limits in a " mixed " or " dual " economy, are pushed far beyond these limits by exponents of crude " purchasing-power " theories and by advocates of state-direction of resource use: that social-welfare outlays provide income-increasing offsets to saving, sustain and expand aggregate expenditure, and thus make for fuller employment; that they permit the production and consumption of goods and services which, being essentially " collective " in character, are not sufficiently amenable to supply by purely private enterprise. Other, and perhaps more effective arguments, are designed to appeal to the " sentiments " and " values " which, in consequence of cultural change and the redistribution of political and economic power, have become more and more effective and conduct-determining. Typical is the increasing appeal to " stability," "security," "equality," and "state responsibility " or " community obligation." [20] Many expenditures for veterans are defended upon sentimental grounds which are carefully insulated from critical examination. Some expenditures, particularly those upon " resource development," are advocated on the supposition, seldom wholly valid, that they will expand national productive capacity. Eventually (but sooner than Herodotus would have supposed) a form of expenditure is accepted as hallowed by time, as proved necessary

[19] The number aged 65 and over will increase from just over 11 millions in 1950 to 25-28 millions in 2000. (See note 27 below.) Presumably significant of the political influence of this group is its success in obtaining liberal old age allowances in the Pacific Coast states.

[20] E. g., see F. E. Dessauer, *Stability* (New York: The Macmillan Co., 1949); O. H. Taylor, "Economic Theory and the Age We Live In," *Review of Economic Statistics*, XXIX (1947), 102 ff.; and "The Economics of a 'Free' Society: Four Essays," *Quarterly Journal of Economics*, LXII (1948), 641-70; E. Halèvy, *L'ère des tyrannies* (Paris, 1938), 214. Halèvy stresses the collectivizing influence of war and the centralized administrations which accompany war. Dessauer argues that the desire for stability has largely superseded the desire for progress in the culture of Western peoples. Taylor reasons similarly, saying that a change in the climate of values emphasizing "security," etc., has immersed most of the American population. He overlooks other sources of this change in emphasis, namely, the redistribution of political power in the direction of the "common man" and the fact that today many contribute to the expression and formation of opinion, whose prototypes were comparatively mute in the nineteenth century. In a paper ("Inflation and Equality," *American Economic Review*, XXXVIII [1948], 892-97) that came to my attention only after this essay was completed, D. M. Wright shows that current egalitarian ideology, together with policies based thereon, most probably will generate secular inflation.

by experience, and as an integral part of the institutional and price structure.[21] Examples are provided by protective tariffs and, more recently, by farm price supports.

Prospective expenditure upon resource development and agriculture must be guessed at. We shall simply suppose that outlay for resource development[22] increases 1.25 times as fast as the national income. In the past, outlay for farm price support, together with agricultural improvements and administration has usually remained under $2 billions, with price supports absorbing under $1 billion. Even so, the potential liability of the government was greater, and it will become greater as the assistance agriculture derives from the foreign-aid program declines.[23] This liability may be further increased if something like the Brannan plan is adopted (as it eventually must be if the opposition of the urban electorate is to be placated), and relatively high support prices are adopted. In general, the cost of a plan of this sort varies directly with the height of the support prices and the elasticity of supply of the affected commodities, and inversely with the elasticity of demand for them and the rigor of the production controls imposed. While estimates of its cost are not available, it is evident that, under similar conditions and provided that the "surplus" is consumed under the Brannan type of plan but not under the alternative plan, the former will not cost much (if any) more, while at the same time it will reduce the cost of living and thus diminish existing upward pressure against wage and price levels. Lacking definitive information, therefore, we shall suppose outlay upon agriculture and its support to increase somewhat more rapidly than the national income. It is possible, of course, that, because of the increased demand for agricultural products provided by a rising national income, the present outlay may no more than double.[24] At the same time it

21 "Nothing is impossible in the long lapse of the ages," wrote Heredotus (*Histories*, IV, 9). It was probably the institutional aspect of the practice that led Octavius Augustus to remark: "I was strongly inclined to abolish forever the custom of distributing grain to the people at public expense.... But I did not carry out my purpose, feeling sure that the practice would one day be renewed by some one ambitious of popular favor" (Suetonius, *The Lives of The Twelve Caesars* [Modern Library ed.], p. 80).

22 In this category we include outlays for nonagricultural resources, transportation and communication, finance, commerce, industry, labor, education, general research, housing and community facilities. In preliminary fiscal 1950 estimates these items aggregated $4.5 billions. The S_1 and S_2 estimates (in billions of dollars) are, respectively: 1960, 5.5 and 6.2; 1970, 6.6 and 8.3; 1980, 7.8 and 10.2; 1990, 9 and 14; 2000, 10.4 and 17.1. The L_1 and L_2 estimates (in billions of dollars) are: 1960, 5.5 and 6.2; 1970, 7.1 and 8.9; 1980, 8.7 and 12.1; 1990, 10.4 and 15.9; 2000, 12 and 20.4.

23 E. g., see *Monthly Letter* of the National City Bank, October, 1948, p. 117. Aid to agriculture aggregated $2,661 millions in fiscal 1949 and $1,519 millions in the first seven months of calendar 1949. This coming crop year the cost of price supports may exceed $2 billions. The commitments of the Commodity Credit Corporation may aggregate nearly $5 billions.

24 We suppose that the outlay will increase from $2 billions in 1950 to $4 billions in 1960 and $5 billions in 1970 and thereafter will increase only one-half as fast as the national income. The L_1 and L_2 estimates (in billions of dollars) for later years are: 1980, 5.5 and 5.8; 1990, 6 and 6.6; 2000, 6.4 and 7.5. The corresponding S_1 and S_2 estimates (in billions of dollars) are: 1980, 5.4 and 5.7; 1990, 5.8 and 6.3; 2000, 6.2 and 7.1.

Estimates of the cost of the Brannan plan differ greatly. The American Farm Bureau estimated at $2 billions the cost of the milk program alone. Secretary Brannan, however, in a statement before the House Committee on Agriculture (April 25, 1949) mentioned these costs: hogs, $230 millions; eggs, $172 millions; milk and milk products, $159 millions; potatoes, $225 millions. Actually, given

must be remembered that in so far as agricultural benefits are capitalized into the sale value of farm land, the demand for *recurring advances* in benefits is strengthened.

In view of the past success of veterans' drives for pensions [25] and in light of the usual acquiescence of Congress in demands for pensions and bonuses, it is almost certain that a liberal general pension bill will be passed, and highly probable that a Federal bonus program will be adopted. While it is not yet clear what provision will be made, an index of future outlays in the form of age-pensions is provided by H. R. 1693, and in the form of bonuses by a proposal that would probably cost over $50 billions. Age pensions alone, under H. R. 1693, rise from $525 millions in 1950 to a peak of $7,992 millions in 1989. Although this bill initially failed of passage, others having like effect, it may safely be assumed, eventually will be adopted. In time, too, the pensions will be increased, and other benefits will be provided.[26]

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identical support prices and provided that under the Brannan plan the total supply is to be sold while under the alternative plan the "surplus" in excess of what can be sold at the support price is to be destroyed, the cost of the two plans will be the same, if the arc elasticity of demand below the support price is unity. If it exceeds unity, the Brannan plan will cost less; if it is less than unity, more. But in each instance the community gains whatever value it attaches to the "surplus" that would otherwise have been destroyed. The same argument holds if a school-lunch or similar arrangement is combined with both plans. That the long-run adjustment problem in agriculture is less difficult than is usually assumed is suggested by C. Kaysen and J. H. Lorie, "A Note on Professor Schultz's Analysis of the Long Run Agricultural Problems," *Review of Economic Statistics*, XXX (1948), 286 ff.

[25] Not until the closing years of the Civil War did veterans' pensions begin to mount, but thereafter they rose rapidly, increasing about 4 per cent per year in 1870-1920 and about 3.5 per cent in 1920-39. Under the impetus of population growth and technological progress, national income in current dollars increased about 4.5 per cent per year in the former period. But in 1920-39 the national income in current dollars rose only 2 per cent; whence the pension burden almost doubled. In 1939-48 veterans' pensions increased 400 per cent while current national income was rising 212 per cent. On the pension question see A. A. Friedrich, "Veterans," *Encyclopaedia of the Social Sciences* (New York, 1935), XV, 245-46. See also W. H. Glasson, *Federal Military Pensions in the United States* (New York, 1918); Katherine Mayo, *Soldiers What Next!* (New York, 1934); Talcott Powell, *Tattered Banners* (New York, 1933). The current drive for pensions began in late 1948 when the American Legion reversed its long-standing policy against a general pension and demanded one. See Austin Stevens' report in *New York Times*, October 22, 1948, p. 15. Previously the Legion had opposed a general pension on the ground that granting it would tend to hold down the amount of pension obtainable by veterans with war-connected and other approved forms of disability.

[26] In 1948-49 veterans' benefits and services entailed an outlay of $6.7 billions. (On their character, etc., see I. H. Siegel and M. F. W. Taylor, "Public Expenditures for Veterans' Assistance," *Journal of Political Economy*, LVI (1948), 527-32. Some commitments are terminating, while others are increasing. Hence we shall suppose a constant annual outlay of $4.5 billions for these various purposes. We obtain our estimates of future outlays for veterans by adding to this figure the following sums, representing age pensions only under H. R. 1693 (in millions of dollars): 1950, 525; 1960, 2,411; 1970, 2,461; 1980, 4,442; 1990, 7,985; 2000, 3,990.

Our estimates are probably too low. For example, H. R. 1693 included, besides provisions for widows and dependents, disability provisions which, it appears, would raise the cost 25-30 per cent or more. When H. R. 1693 failed very narrowly of passage, other bills providing smaller benefits were considered. One of these would provide a "bonus" of $3 for every day of stateside service, $4 for every day of foreign service, and $500 for a wound—subject to a limitation of $3,500 for veterans without foreign service and $4,500 for those with foreign service. This bill probably would cost over $50 billions. On the estimated cost of the various provisions of various bills, together with the attitude of members of Congress and others, see *Hearings* before the Committee on Veterans' Affairs, House of Representatives, 81st Cong., 1st sess., on H. R. 1693, 3821, 4617, and other bills considered in January-July, 1949.

The social security component of the budget is more susceptible of expansion than any other. It may rise from $2.4 billions in 1950 to $39-60 billions in 2000, with O.A.S.I. (old-age and survivors insurance) comprising more than half this amount, and with social insurance and related benefits (public assistance; health, unemployment, and disability insurance; and outlays for the general health and welfare) making up the rest. The magnitude of the social security aggregate will be governed, of course, by the extent and kind of coverage provided.[27] If family allowances are added, the aggregate cost will be

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Alternative estimates are reached by assuming that the aggregate outlay for veterans increases 1.25 times as fast as the national income and starting with $6.5 billions in 1950. On this assumption we get the following L_1 and L_2 estimates (in billions of dollars): 1960, 8 and 9; 1970, 10.3 and 12.9; 1980, 12.6 and 17.5; 1990, 15 and 23; 2000, 10 and 15.3. The corresponding S_1 and S_2 estimates (in billions of dollars) are: 1960, 8 and 9; 1970, 9.6 and 12; 1980, 11.3 and 15.7; 1990, 13.1 and 20.2; 2000, 8.7 and 13.4. (In each instance it is supposed that the 2000 figure is one-third below the 1990 figure in consequence of the reduction in the number of veterans.)

[27] Estimated aggregate minimum and maximum outlays (in billions of dollars) for public assistance, general health and welfare, and insurance respecting health, temporary disability, and unemployment are: 1960, 9.8 and 14.7; 1970, 11.9 and 15.4; 1980, 12.8 and 16.4; 1990, 13.8 and 17.4; 2000, 14.7 and 17.9. These figures are taken from *Hearings* before the Committee on Ways and Means on H. R. 2893, House of Representatives, 81st Cong., 1st sess., March-April, 1949, p. 2023. The corresponding O.A.S.I. minimum and maximum estimates (in billions of dollars) are: 1960, 4.7 and 7.1; 1970, 7.6 and 10.9; 1980, 10.1 and 14.7; 1990, 12.2 and 18.2 (19.3); 2000, 13.1 and 20.6 (22.6). The figures in parentheses are from *ibid.*, p. 1322; the others are from *Actuarial Study No. 28*, February, 1949, issued by the Federal Security Agency. I have used, instead of these O.A.S.I. estimates, the following which are based upon somewhat different assumptions that are discussed below. The S_1 and S_2 estimates (in billions of dollars) are: 1960, 4.9 and 7.3; 1970, 8.3 and 12.1; 1980, 12.9 and 19.3; 1990, 18.2 and 29.4; 2000, 24.2 and 38.3. The corresponding L_1 and L_2 estimates (in billions of dollars) are: 1960, 4.8 and 7.3; 1970, 8.7 and 16.2; 1980, 13.5 and 20.3; 1990, 19.4 and 30.2; 2000, 26.5 and 42. The aggregate estimated outlays for social security under S_1 and S_2 assumptions, used in the text above (in billions of dollars) are: 1960, 14 and 17; 1970, 20 and 24; 1980, 26 and 32; 1990, 32 and 43; 2000, 39 and 53. The corresponding L_1 and L_2 estimates (in billions of dollars) are: 1960, 19 and 22; 1970, 24 and 28; 1980, 30 and 37; 1990, 37 and 48; 2000, 44 and 60.

I arrived at the O.A.S.I. estimates as follows. I converted the estimated benefit payments reported in *Actuarial Study No. 28* into units of about $725 a year (i. e., about $60 per month) as of 1960. The minimum and maximum number of these units per 100 persons aged 65 and over approximated 45 and 68 in 1960; 60 and 79 in 1970; 70 and 86 in 1980; 77 and 89 in 1990; and 90 and 96 in 2000. My population estimates indicate the following approximate numbers of persons aged 65 and over: 1960, about 14.8 millions; 1970, 17.4 and 18.1; 1980, 20.8 and 21.9; 1990, 24.1 and 25.8; 2000, 24.9 and 27.3. These figures are then converted into units receiving about $725 per year, on the basis of the number per 100 persons aged 65 and over, given just above. It is not reasonable to assume that the $725 rate will remain unchanged in the face of rising per capita incomes. Accordingly, we have supposed it to increase at the same rate as per capita national income, namely, 1 and 2 per cent per year to arrive at L_1, S_1, L_2, and S_2 estimates. We thus suppose, as of 2000, payments per unit of about $1,080 and $1,600 per year. These figures compare with $2,302 and $3,268, the amounts to which a per capita income of $1,400, as of 1950, will increase by 2000 at annual growth rates of 1 and 2 per cent, respectively.

The estimates in *Actuarial Study No. 28* are based in part upon two estimates of the population aged 65 and over, according to one of which the number increases gradually from 11.2 millions in 1950 to a maximum of 19.5 millions in 1990, and according to the other of which the number rises from 11.4 millions in 1950 to 28.5 millions in 2000. The magnitude of the monthly benefit payment per unit increases relatively little, however.

In the spring of 1949 just over three-fifths of the civilian labor force was covered by O.A.S.I.; and slightly over one-half by state unemployment insurance. For a summary of the changes proposed in coverage, benefits, etc., which are incorporated in the estimates given in *Actuarial Study No. 28* and underlie the alternative estimates I present above, see *Social Security Bulletin*, XI (1949), 3 ff., 21 ff.

greatly increased.[28] The cost of social security will be met in part out of contributive taxes imposed for this purpose, and in part out of general revenue.[29]

Let us now put these governmental expenditure estimates together and compare them with the national income, on the supposition that we start with a national income of $220 billions and $55 billions of governmental expenditure in calendar year 1950, and that national income increases at the rates indicated in columns 4-5 and 8-9 of Table 1.[30] The relevant data are given in Table 3.

TABLE 3

GOVERNMENTAL EXPENDITURES EXPRESSED AS A FRACTION OF NATIONAL INCOME, 1950-2000

Year	Governmental Expenditures ÷ National Income			
	S_1	L_1	S_2	L_2
1950 ..	25	25	25	25
1960 ..	.294-.299	.314-.318	.295-.302	.313-.320
1970 ..	.303-.312	.309-.319	.294-.307	.298-.313
1980 ..	.312-.319	.312-.321	.294-.308	.294-.311
1990 ..	.322-.324	.319-.328	.299-.312	.279-.297
2000 ..	.314-.315	.305-.308	.287-.293	.283-.292

Three conclusions are suggested. (1) Under the conditions assumed, the ratio of governmental expenditure to national income approximates or slightly exceeds the 30 per cent level in 1960. Under S_1 and L_1 conditions it remains there while under S_2 and L_2 conditions it may move slightly below the 30 per cent level. (2) Contrast of the ratios in Table 3 with those presented earlier in this section indicates that our assumptions respecting the future course of governmental expenditure yield a lower and more stable expenditure–income ratio than did the projections of past ratios into the future. (3) While the ratio moves inversely with rate of growth of per capita income, the influence of this rate is reduced, as is that of the rate of population growth, by

[28] With the number of children under 17 approximating 40-47 millions, a system of allowances providing $500 per child under 17 would cost $20-23.5 billions.

[29] At the time of the hearings employee-employer contributions (2 per cent) of payrolls were covering less than half of the level-premium cost (4.5 per cent). Expanded O.A.S.I. and disability insurance would cost, on an average, about 7.4 per cent of the payroll under existing conditions, but only 6 per cent if payrolls increased about 2 per cent per year. O. Altmeyer proposed that employer-employee contributions cover about 4 of this 6 per cent. See *Hearings* (cited in note 27, above), pp. 1094-1095, 1316, 1322. The estimates I give would cost more.

[30] There follow the aggregates of government expenditures (in billions of dollars) based upon the estimates reported in notes 17, 22, 24, 26, and 27. S_1: 1960, 77-78; 1970, 92-95; 1980, 109-111; 1990, 128-129; 2000, 142. S_2: 1960, 85-87; 1970, 109-114; 1980, 138-145; 1990, 176-184; 2000, 211-216. L_1: 1960, 82-83; 1970, 99-103; 1980, 120-124; 1990, 143-146; 2000, 157-159. L_2: 1960, 90-92; 1970, 117-123; 1980, 153-161; 1990, 186-197; 2000, 238-245. In all four instances the 1950 figure is $55 billions. The national income figures (in billions of dollars) follow, $220 billions being assumed for 1950. S_1: 1960, 260; 1970, 303; 1980, 349; 1990, 398; 2000, 451. The corresponding S_2 figures are: 287, 369, 470, 590, 737. The L_1 estimates are: 1960, 260; 1970, 322; 1980, 385; 1990, 449; 2000, 514. The corresponding L_2 figures are: 287, 392, 518, 666, 841. The percentages in Table 3 are derived from the preceding figures.

A balanced budget would not imply that all revenue was derived from "taxes" as such. In the calendar year 1948, nontax receipts aggregated $1,620 (state, $1,278; Federal, $342) millions in a net of $60,173 millions. In fiscal 1948 4.8 per cent of all revenue was provided by "charges and miscellaneous." See *Governmental Revenue in 1948* (Government Finances in the United States: 1948, No. 3) (Washington: U. S. Bureau of Census, August, 1949), p. 9. The above and the subsequent discussion is based, therefore, on the supposition that these sources of revenue are included with taxes.

the assumptions employed. If the minimum (i. e., S_1 and S_2) estimates of outlays for social security other than O.A.S.I. are combined with the maximum (i. e., L_1 and L_2) estimates for O.A.S.I., the L_1 and L_2 ratios are reduced only 2-3 per cent after 1960. If, however, the growth of public expenditure is made more dependent upon the rate of growth of per capita income and less dependent upon that of population growth (and therefore less dependent upon the rate of growth of national income), the L_1 and L_2 ratios become lower relative to the S_1 and S_2 ratios. For example, if the estimates of some outlays (veterans' benefits, agriculture, and social security) are allowed to stand while the remaining estimates are based upon the rate of growth of *per capita* income (instead of upon that of *national* income), the L_1 and L_2 ratios become 27.7 and 26.6 per cent for 1970 and 26.6 and 24.3 per cent for 1990. The corresponding S_1 and S_2 ratios become: 1970, 28.1 and 27.2; 1990, 28.7 and 26.6. It is, of course, unlikely that the rate of growth of per capita income can be made the overwhelming determinant of the growth of public expenditure, since some of its components are affected also by the rate of population growth.

In the next section it is contended that the government-expenditure : national-income ratio has a ceiling value in nontotalitarian economies. If this ceiling be hypothetically set at 25 per cent, the absolute excess may be determined, and selective expenditure cuts may then be indicated. Since the excesses under our various assumptions range between \$12 and \$38 billions, the obvious and indicated restriction of agricultural and veterans'-benefit expenditures to \$2 and \$4.5 billions, respectively, will not suffice; for such restriction reduces aggregate outlay by only \$4 to \$20 billions. If, however, we combine with this restriction the assumption made near the close of the preceding paragraph (i. e., that the growth rate of *per capita* income dominates that of governmental expenditures), the ratio is just above 25 per cent for 1970, given S_1 and S_2 conditions, and slightly below it for 1990. Given L_1 and L_2 conditions, the ratio is just above and just below 25 in 1970 and at the 25 and the 22.5 levels in 1990. In general, under these circumstances, the ratio falls.[31]

III. IMPLICATIONS: (A) THE TAX-INCOME RATIO

Our analysis up to this point suggests that public expenditures will rise more rapidly than national income in the future. This conclusion, if valid, di-

[31] Let G = total annual governmental expenditures;
G_o = total governmental expenditures in base year;
P = population;
P_o = population in base year;
i = annual rate of growth of population ($i > 0$);
y = per capita income;
y_o = per capita income in base year;
r = annual rate of growth of per capita income;
n = number of years beyond base year.

If we assume that, approximately,

$$G = ky \qquad (k = \text{constant}),$$

and if R denotes the ratio of governmental expenditures to national income, then

$$R = \frac{G}{Py} = \frac{G_o(1+r)^n}{P_o(1+i)^n\, y_o(1+r)^n}.$$

R must fall as n increases since, under circumstances such as are here assumed, the growth of the numerator is proportional to that of y only, whereas the growth of the denominator is governed by that of both y and P.

rects our attention to several problems whose importance will be greatly augmented by a significant further increase in the ratio of tax-revenue to national income. (A) Are the anticipated ratios in excess of what the American taxpayers will support? And if so, what will be the outcome? Our discussions of (A) will be conducted on the assumption that the supply of labor and resources will not be adversely affected, at least in the short run.

(B) How will the prospective increase in the tax-connected transfer of income [32] affect the disposition of individuals and of the community as a whole to put forth work and effort? If this effect is adverse, the effects discussed under (A) will be reinforced. Questions (A) and (B) will be discussed in order.

It should be noted, before we turn to consider (A), that the prospective increase in the relative amount of governmental expenditure may affect the rate of growth of national income in ways not considered under (B). For example, if gross and net saving and investment are reduced, equipment per worker, and therefore output per worker, will increase less rapidly than otherwise.[33] Again the composition of government expenditures and output is relevant. If these expenditures serve to augment public capital, to improve the nation's natural resources, to expand the educational and cultural equipment of the population, and so on, per capita income will rise more rapidly than if they are devoted to unproductive purposes. The effect of the amount and of the character of public expenditure upon the fullness of employment is not considered, since it lies outside the scope of this paper.

At any given time, supposedly, there is an upper limit to the aggregate amount that taxpayers are willing to surrender to the state. This limit may be expressed as a fraction of the national income Y ($= Py$), or of the net national product (NNP $= Y$ plus indirect tax and nontax liability), or of gross national product (GNP $=$ NNP plus capital consumption allowances). This limit is variable, being governed by a number of circumstances: the make-up of the tax structure, the composition of governmental expenditure, the extent

[32] For several centuries the effects of income transfers under governmental auspices—usually debt interest—has aroused the concern of economists. Adam Smith and J. S. Mill noted that a transfer of debt interest is more than a bookkeeping transaction. J. F. Melon (*Essai politique sur le commerce* [Paris, 1761], chap. 23) had observed that the debts of a state merely entail payment by the right hand to the left. This Adam Smith denied respecting even a domestically held national debt, saying that the transfer of funds for this purpose from the owners of land and capital to interest-receivers tended to make for a less efficient use of land and capital. J. S. Mill also considered such transfers vexatious and unfavorable to production. See A. Smith (E. Canaan, ed.), *The Wealth of Nations* (New York: The Modern Library, 1937), Bk. V, chap. 3, 879-81; J. S. Mill (W. J. Ashley, ed), *Principles of Political Economy* (New York: Longmans Green Co., 1921), Bk. V, chap. 7, 876 ff. The nature of the "burden" occasioned by transfers associated with domestic debt has been treated by B. U. Ratchford, "The Burden of a Domestic Debt," *American Economic Review*, XXXII (1942), 451-67, and C. C. Abbott, *The Management of the Federal Debt* (New York: McGraw-Hill Book Co., 1946). See also J. E. Meade, "Mr. Lerner on 'The Economics of Control,'" *Economic Journal*, LV (1945), 61-66, and T. Balogh's reply in *ibid.*, pp. 461-63.

[33] See e. g., R. A. Musgrave and M. S. Painter, "The Impact of Alternative Tax Structures on Personal Consumption and Savings," *Quarterly Journal of Economics*, LXII (1948), 475-79, and E. D. Domar and R. A. Musgrave, "Proportional Income Taxation and Risk-Taking," *ibid.*, LVIII (1944), 388-422.

to which public expenditure is compatible with the principles of voluntary exchange,[34] the distribution of the taxing power between central and local governments, the nature of the economy (free-enterprise, mixed, state-dominated, totalitarian), the measure in which prices are formed in accordance with the rules obtaining under pure competition, the degree of equality with which income is distributed, the character of the prevailing savings and investment functions, and the system of attitudes that prevails with respect to what the government may appropriately do and how it may do it.

When this tax limit is reached, any increase in governmental expenditures results in a deficit. If this deficit is financed by credit expansion (or by printing new money), the level of money national income will rise. A rise in money income, generally speaking, will be accompanied by a rise in real national income so long as the economy is workably competitive and relatively important agents of production are in highly elastic supply or can be replaced by equivalently economical substitutes. When there no longer exists a reserve supply of productive agents to hold down prices of their services, real national income is in the neighborhood of its attainable maximum, and further increases in money income will result in increases in the price level.

When tax collections are equal to the maximum that the community is willing to pay and real national income is at its attainable maximum, efforts to increase governmental expenditures are bound to be inflationary. Let us call this state the tax-maximum equilibrium. Now suppose that the underlying political situation and the prevailing distribution of political power are incompatible with the maintenance of this equilibrium. Suppose that some of the various actual or would-be recipients of governmental disbursements bring about an increase in expenditures. Prices will rise and reduce both the real value of money income distributed by the government (salaries, pensions, supplements, etc.) and its command over factors of production. Accordingly, some if not all of the adversely affected groups will take steps to have their money incomes augmented sufficiently to counterbalance the price rise, but with effects similar to those just described. In general, then, so long as the nation's stock of money is sufficiently expanding, and the groups receiving income from the government are sufficiently powerful to obtain what are intended to be price-increase-offsetting increments in income, the price level will trend upward.

Is there empirical evidence of an upper limit to the fraction of the national income that taxpayers in nontotalitarian countries stand ready to surrender to the state? Colin Clark as-

[34] i.e., is governed solely by rational economic considerations. See R. A. Musgrave's description and appraisal of this theory in his "The Voluntary Exchange Theory of Public Economy," *Quarterly Journal of Economics*, LIII (1939), 213-37. On circumstances which make difficult the giving of adequate consideration to rational economic considerations, see also H. R. Bowen, "The Interpretation of Voting in the Allocation of Economic Resources," *ibid.*, LVIII (1943), 27-48; P. J. Strayer, "Public Expenditure Policy," *American Economic Review*, XXXIX (1949), 383-402; and J. M. Buchanan, "The Pure Theory of Government Finance: A Suggested Approach," *Journal of Political Economy*, LVII (1949), 496-505.

sures us there is, stating that pre- and postwar experience reveals it to range between 20 and 25 per cent and at present not to exceed the latter figure. When this limit is passed, there is gradually set in motion a constellation of inflation-fostering forces. If a truly equilibrium condition obtained, compensatory counterforces would come into play. But such a condition does not prevail and is unlikely to come into being. Consequently the inflationary forces are overriding, and the price level rises.

Inasmuch as the full development of Clark's argument would constitute a paper in itself, we shall confine our discussion to detailing and dovetailing the elements of his thesis. When the tax ceiling (say 25 per cent) is exceeded, "influential sections of the community become willing to support depreciation of the value of money; while so long as taxation remains below this critical limit, the balance of forces favors a stable, or occasionally an increasing, value of money."[35] Large-scale taxpayers see in an unbalanced budget, together with some inflation and price increases, a means of easing the *real* tax burden. Wage earners demand wage increases, in part in the belief that they will reduce the burdensomeness of their unaccustomedly high tax load. Employers, particularly when they are subject to high marginal tax rates, acquiesce readily in demands for higher wages, bonuses, etc., and sanction with little qualm the wasteful use of resources in advertising, selling, etc. Exporters become enamored of currency devaluation. Politicians find in this climate much to reinforce their natural preference for spending to tax collecting. All classes find their "incentive to real effort greatly weakened." The aggregate effect of these pressures is an unbalanced budget, deficit financing, increased bank credit for private use, and eventually rising prices.

The situation just described is analogous to that obtaining in an economy in which both trade unions and business units are powerful and aggressive, the former in pushing up money wages and the latter in maintaining (when not increasing) profits, whilst the government is committed to preserving full employment. In these circumstances the money stock is almost certain to be expanding, and price, wage, and (probably) profit levels tend to be advancing.[36] In this situation as in the one

[35] See "Public Finance and Changes in the Value of Money," *Economic Journal*, LV (1945), 371-89, esp. p. 380, and "The Value of the Pound," *ibid.*, LIX (1949), 205-06. The inflationary process is outlined in the former article. See also F. D. Graham's account of the political forces making for inflation in Germany after World War I, in *Exchange, Prices, and Production in Hyper-Inflation: Germany, 1920-1923* (Princeton, 1930), p. 11. Reports from Britain frequently stress the lack of incentive to reduce costs by eliminating disguised unemployment, etc., in industry. E. g., Raymond Daniell's report in the *New York Times*, August 28, 1949, I, 1, 25.

[36] See M. W. Reder's analysis in "The Theoretical Problems of a National Wage-Price Policy," *Canadian Journal of Economic and Political Science*, XIV (1948), 46-61; also H. W. Singer's "Wage Policy in Full Employment," *Economic Journal*, LVII (1947), 438-55, and Singer's reply to J. H. Richardson's criticism, *ibid.*, LVIII (1948), 421-25. I have approached this question from a slightly different angle in "The Role of the State," *Journal of Economic History*, VII, Supplement VII (1947), 123 ff., and "The Problem of Order in Economic Affairs," *Southern Economic Journal*, XV (1948), 1 ff. The President's so-called fact-finding committees, lacking the guidance of a body of principles that reflect the interest of the public as well as that of the bargaining parties, have largely if not wholly disregarded the inflationary impetus arising out of their "recommendations."

previously described, the rate of advance of price, wage, and money-income levels is conditioned by the rate of expansion of the money stock. This expansibility is a necessary condition, and its control is an important element in the solution of both the fiscal and the wage-price problem.[37] In view of the fact that average real weekly wages cannot increase much more than 2 per cent per year, if so much, efforts to increase this rate more rapidly will generate either inflation or unemployment.[38]

It is evident, if Clark's findings are valid and applicable to the American scene, that continuing effort on the part of the government to push the level of public expenditures and tax collections appreciably above the 25 per cent mark will tend to initiate and sustain an upward movement of the price level. This upward movement will be intensified, moreover, so long as relatively full employment obtains and effective price and wage controls are lacking (as they almost certainly will be), by the continuing pressure of organized labor to advance the wage level faster than consumer prices, and by the continuing effort on the part of employers to pass these wage increases (and perhaps more) on to their customers. This upward movement will continue even though the rate at which the national income grows is not adversely affected by the expenditure policy of the government; and it will be stepped up if, as seems probable, the growth rate is slowed down. While the imposition of limits upon the growth of the money supply will reduce the force of this upward movement, it will reduce it only in part, since the strength of the upward movement is conditioned only in part by the growth of the money supply.

It may be noted in passing that if it be true that there is an upper limit to the relative amount of revenue which may be raised through taxation, then the range of alternative paths to full employment is more narrow than has been supposed. It has been demonstrated, for example, that the ratio of tax revenue to national income (or net national product) may vary, under full employment, between a minimum and a maximum five or six or more times the minimum in size.[39] The

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[37] Careful students of the problem have emphasized this fact. E. g., see Milton Friedman, "A Monetary and Fiscal Framework for Economic Stability," *American Economic Review*, XXXVIII (1948), 245 ff.

[38] This has been confirmed by past experience. In manufacturing, hourly money earnings increased 34.5 per cent in 1945—(December) 1948 and 117.4 per cent in 1939—(December) 1948; corresponding increases in hourly real earnings approximated only 26 and 8 per cent. The strenuous post-1945 wage drive did not step up the rate of increase significantly, price increases consequent in part upon wage increases cancelling much of the latter. In 1929-41, a period marked by sharply falling and then fairly stable consumer prices, *real* hourly earnings rose 50 per cent, or 3½ per cent per year; in 1929—(December) 1948, 74 or about 3 per cent per year.

[39] See H. C. Wallich, "Income Generating Effects of a Balanced Budget," *Quarterly Journal of Economics*, LIX (1944), 78-91; J. C. Hubbard, "The Proportional Personal-Income Tax as an Instrument of Income Creation," *Economic Journal*, LIX (1949), 56-67; A. H. Hansen, "Three Methods of Expansion through Fiscal Policy," *American Economic Review*, XXXV (1945), 382-87; R. A. Musgrave's exposition of the interrelations obtaining among the relevant economic variables, "Alternative Budget Policies for Full Employment," *ibid.*, pp. 387-400. See also W. Beveridge, *Full Employment in a Free Society* (New York: W. W. Norton and Co., 1945), pp. 363 ff.; P. A. Samuelson, *Economics* (New York: McGraw-Hill Book Co., 1948), p. 441. The ratios implicit in the various full-employment

applicability of this demonstration is limited, however. It has been confined to the formal, mathematical aspects of the problem. It has ignored the fact that at bottom the range of choice open to formulators of fiscal policy is politically determined, since the constraints arise from political circumstances. Accordingly, if these circumstances make impossible the simultaneous attainment of a balanced budget and full employment, then the maintenance of the latter presupposes deficit (or loan) financing and an expanding debt. The formal analysis of the problem has revealed, however, that, under the conditions assumed, deficit financing entails a smaller amount of public expenditure and, therefore, permits a greater measure of consumer sovereignty and probably of consumer welfare than does balanced-budget financing.[40]

IV. IMPLICATIONS: (B) THE SUPPLY OF EFFORT

The transfer of income, under government auspices and in the initial form of taxes, from some individuals to others affects the behavior of both. These effects may be divided into (a) those incident upon the receivers and (b) those incident upon the suppliers of tax revenue. Our discussion in this section will be conducted upon the assumption that full employment prevails, since we may thereby avoid or neutralize effects not here under consideration.

Receivers of Transfers

The receiver of an increment of income, receipt of which is not contingent upon the receiver's rendering a *quid pro quo* in the form of work, will almost invariably put forth less effort in consequence of the receipt of such income. For the income elasticity of demand for leisure of nearly all individuals being positive, the representative individual, under the circumstances assumed, will increase his consumption of leisure time and consequently devote less time to work than otherwise. He will respond in this way whether he receives the increment currently, or subsequently in the form (say) of a pension after he has withdrawn from the labor force. For in the latter case he will look upon the pension as deferred income (its present value to be arrived at by discounting the waiting period and the uncertainty it entails). The prospect of receiving this income relieves him of the necessity he otherwise would be under of working, earning, and setting aside income for his support after his withdrawal from the labor force. Only if his subjective standard of living rises enough and immediately will the receiver's disposition to work not be reduced; and such an immediate rise is out of question.

Theory and experience confirm what has been said. It follows necessarily from indifference analysis. It follows from the fact that the length of the working week has been reduced as output per worker has risen. It has been

models are not the same as ratio of tax revenue to national income, since gross or net national product is usually given in place of national income and transfer expenditures are omitted; but they resemble Clark's and support the same conclusion.

[40] This deficit financing, of course, generates an amount of tax revenue that is smaller than the initiating deficit expenditure. See P. A. Samuelson, "Theory of Pump-Priming Reexamined," *American Economic Review*, XXXV (1940), 492-506, and "Fiscal Policy and Income Determination," *Quarterly Journal of Economics*, LVI (1942), 581 ff.

substantiated by studies which reveal that an increase in wage rates is accompanied by a decline in the short-run supply of hours of labor per worker.[41]

It follows from what has been said that the bestowal of pensions and bonuses upon war veterans and the disbursal of unearned income or credits to agriculturalists, workers, and others who are members of free-income-seeking pressure groups, operates to reduce the amount of effort that the recipients of this free income put forth. For only if the receipt of this free income is offset by a compensatory decrease (e. g., through increased taxation) in the recipient's other income will this effect be avoided; and such compensatory decrease is extremely improbable. As we indicate below this effort-decreasing effect is not counterbalanced by a flow into use of work (or effort) that otherwise would not have been forthcoming.

Taxpayers

The aggregate effect of a tax increase upon the growth of national income is less easy to assess than is the effect of the policies considered above. For the aggregate effect is made up of three separate effects: (i) the change in the supply of effort consequent upon the tax increase—a change that issues out of the substitution *and* the income effects imputable to the tax increase; (ii) the response of dynamic, progress-producing forces to the change described under (i); and (iii) the manner in which the productive effectiveness of the working masses is influenced by the change treated under (i). We shall examine effects (ii) and (iii) briefly and then turn to effect (i).

For purposes of discussion let us assume that the amount of effort being supplied by the professional and the entrepreneurial classes is reduced. (The validity of this assumption will be examined when we treat effect [i]). Then the effects listed under (ii) and (iii) will operate to make the national income less than it otherwise would have been. First, since the supply of professional and entrepreneurial effort is reduced, and since the volume of dynamic change-producing stimuli is positively correlated with the amount of this effort, the rate of income-producing progress will be reduced. Second, a pronounced complementary relationship obtains between the mass of the working population and the active supply of enterprise, professional effort, technical leadership, and management. In consequence the level of productivity and output of which the working population is capable depends in an appreciable degree upon this supply. Accordingly, a diminution in this supply must act to depress the productivity

41 See D. H. Robertson's paper, written in 1921 and reprinted in his *Economic Fragments* (London: P. S. King and Son, 1931), pp. 8-13. Factual information has been supplied by Paul H. Douglas in a number of studies. E. g., see his *The Theory of Wages* (New York: The Macmillan Co., 1934), chap. 12. For theoretical discussions see L. Robbins, "On the Elasticity of Demand for Income in Terms of Effort," *Economica*, X (1930), 123 ff., and J. R. Hicks, *Value and Capital* (Oxford, 1948), chap. 2. Workers differ in their response to income increases, the variation reflecting principally differences in social background. E. g., see M. Dalton, "Worker Response and Social Background," *Journal of Political Economy*, LV (1947), 323-32. For a brief but careful account of possible effects of the income tax on the supply of labor and of the inadequacy of our knowledge respecting some of these effects see R. Goode, "The Income Tax and the Supply of Labor," *Journal of Political Economy*, LVII (1949), 428-37, which came to my attention after this paper was completed.

of the mass of the working population below what it otherwise would have been.

We turn now to crucial effect (i). This effect is the sum of two opposite effects of an increase in the amount of taxes incident upon an individual's income: (1) a substitution effect; (2) an income effect. (1) When a tax increase reduces an individual's after-tax income, it diminishes the price he gets per hour for his work-time, thereby cheapening the cost to him of increasing the relative number of hours that he devotes to not-working or leisure. It always operates, therefore, by reducing the relative price of leisure time, to set up a *substitution effect* in favor of leisure-time and against work-time. Hence leisure-time is increased at the expense of work-time. (2) A tax increase always reduces an individual's after-tax income, thereby disposing him to work more so that he may make up in part the reduction in his after-tax income. This *income effect*, therefore, increases the individual's disposition to work whereas the substitution effect reduces it. The *net* effect, being the *sum* of the *substitution* and the *income* effects, depends on which of these two is the more powerful. It is affected, therefore, by the kind of tax increase imposed upon the individual. For if the increase is primarily or wholly incident upon the taxpayer's *marginal* income, the ratio of the magnitude of the substitution effect to that of the income effect will be greater than when the tax is proportional to total income or is a lump sum,[42] and very much greater than when the tax is largely incident upon appropriable "rents" or surpluses. We have been discussing effect (i) in terms of the individual. If we add together the net effects of the tax increase upon all affected individuals, we get the aggregate effect of the tax increase upon the community.[43]

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[42] In proportion as the tax is incident upon the individual's *marginal* income, his reluctance to work is increased, with the result that the comparative attractiveness of leisure increases. If his marginal income is not affected (e. g., when the tax increase is a lump sum independent of the size of his income), the opportunity cost of leisure at the margin is not affected, and his response to the tax increase will be governed principally by his reaction to the reduction in his after-tax income.

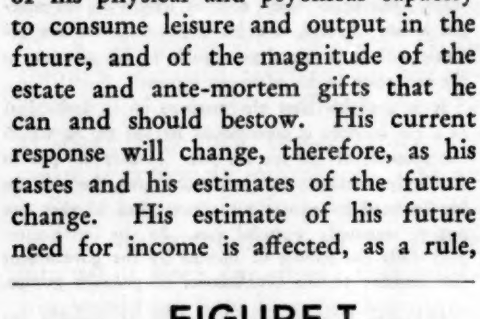
It is probable that the response of an individual to a tax increase is conditioned by the use to which the proceeds of the tax are put. If they are put to seemingly necessary or productive uses, he will be less inclined to reduce his efforts than if they are put to seemingly wasteful uses. In the latter category falls the seizure of income by the government for transfer to the beneficiaries of pressure groups.

[43] Figure I represents the range of possible *net* effects of (1) the substitution effect and (2) the income effect produced by a given tax increase on individuals with varying tastes. Along *OY* is measured after-tax income; along *OL*, the time available per year for work or leisure, with that portion not devoted to leisure being given to work (or effort). (Constancy of output per time period [say, per hour] is postulated for expositive reasons, even though output per time period does vary with conditions of remuneration and work.) The diagonal exchange-ratio lines indicate the value of time in terms of income. Given *YL*, *OL* of time commands *OY* of after-tax income, and one unit of time commands *OY/OL* of such income; given y_2L and y_1L, time is worth less, one unit commanding, respectively, Oy_2/OL and Oy_1/OL of after-tax income. P_1 marks the point of tangency between *YL* and an (undrawn) indifference curve connecting equally attractive combinations of leisure and after-tax income obtained by devoting time to work. At this most attractive point under the conditions given, Ol_3 time is consumed in the form of leisure whilst l_3L time is devoted to work in exchange for l_3P_1 of income. The various other *P*'s mark analogous points of tangency between exchange-ratio lines y_2L and y_1L and other indifference curves. We have indicated only the point of tangency of each curve,

Our discussion of an individual's response to a tax increase has related to a short period of time (e. g., a year). But a man's time horizon is longer, extending forward to the probable date of his withdrawal from the labor force and the time of his death. Accordingly, at any given time an individual's conduct-determining tastes must reflect his present estimate of his future income, of its degree of dependence upon his current earnings, of his future and post-retirement need for income, of his physical and psychical capacity to consume leisure and output in the future, and of the magnitude of the estate and ante-mortem gifts that he can and should bestow. His current response will change, therefore, as his tastes and his estimates of the future change. His estimate of his future need for income is affected, as a rule, by his current after-tax income, since the higher it is, the higher probably will be his present objective and subjective standard of living and his current estimate of his future needs.

We have implicitly assumed that the individual may freely vary the amount of time he works. This assumption is essentially valid for most members of the business and professional classes, at least for those in the upper echelons until they are retired. But it is much less valid for wage earners and others in corresponding income groups, since the maximum number of hours that they may work is largely governed by trade-union agreement, the ruling phase of the trade cycle, and law (or custom), and the minimum, given the phase of the trade cycle, designated by the rules relating to voluntary absenteeism. It is highly significant, however, that

FIGURE I



so as to avoid introducing a confusingly large number of curves from three different sets.

We now apply the diagram by starting with a system of taxes that permits *OL* of time to command *OY* of after-tax income and thus makes P_1 the most attractive division of time between leisure (Ol_3) and work (l_3L). Now suppose two successive increases in the individual's income tax which reduce the value of a unit of his time to Oy_2/OL and Oy_1/OL, respectively. Effects (1) and (2) now become operative, their *sum* depending upon the set of tastes the individual has. If his tastes are represented by a set of indifference curves with points of tangency at P_1, P_2, and P_3, and he wants his after-tax income unchanged, he must divert time from leisure to work. Hence he successively reduces his leisure time to Ol_2 and Ol_1 and increases his work-time to l_2L and l_1L. If his tastes are represented by a set of indifference curves at the opposite pole and with points of tangency at P_1, P_2', and P_3', and he wants his leisure time unchanged at Ol_3, he must undergo successive reductions in income from P_1l_3 to $P_2'l_3$ and $P_3'l_3$. If, finally, the individual's tastes are representable by a set of indifference curves with points of tangency at P_1, P_2'', and P_3'', he will divert time from work to leisure, reducing his work-time successively from l_3L to l_4L and then to l_5L. The aggregate short-run effects of a tax increase are obtained by adding together the responses of all affected individuals who, as Figure I reveals, may work more, fewer, or the same number of hours after the tax increase as before.

our assumption does hold for the former group, even though not for the latter group, since, as was stated earlier, the productivity of wage earners is appreciably influenced by the amount of effort put forth by the professional and the entrepreneurial classes.

Our discussion has been concerned with the supply of effort per individual per year or per productive lifetime. It has not touched upon variation in the number of individuals supplying a particular kind of effort, and in particular, the kind of work or effort that is provided by the entrepreneurial and professional classes. If we suppose both less than full employment and the availability of additional individuals to provide entrepreneurial and professional service, the possible depressive effect of tax increases upon the supply of effort per individual is less significant. But if we suppose either that something like full employment exists, or that the number of individuals capable of supplying professional and entrepreneurial service is comparatively fixed, then it becomes economically very significant if tax increases reduce the supply per person of this sort of effort, since a consequence will be the depression of national income below what it otherwise might have been. While the size of this number is conditioned by non-economic as well as by economic circumstances, its short-run elasticity probably is not great, and its longer-run elasticity is likely to be depressed by such deterioration of prospect as is attributable to tax increases.[44]

Unfortunately, satisfactory empirical evidence respecting the elasticity of the supply of effort on the part of entrepreneurial and professional classes is lacking. It is known that taxes and tax increases strike most heavily at marginal income and thereby intensify the substitution effect.[45] Boulding's analysis suggests that taxes, such as those incident upon profits, tend to reduce the aggregate supply of " enterprise," the factor whose business it is to make profits. For since risk apparently increases with the scale of activity and consequently the supply of enterprise is in general positive, a profits tax tends to " lessen the willingness of business men generally to engage in business and provide employment at any given level of profits." A similar argument probably can be made with respect to the supply of some forms of professional service. It is demonstrable also that a progressive income tax tends to reduce the supply of effort more than does a proportional tax.[46]

[44] Robertson (*op. cit.*, pp. 40, 18-19, 22) questions whether the supply of business ability is appreciably affected by the level of taxation. In the late 1920's about 57 per cent of all " business leaders " came from business families (see F. W. Taussig and C. S. Joslyn, *American Business Leaders* [New York: The Macmillan Co., 1932]). This suggests that, under American conditions, the source of the supply is comparatively restricted.

[45] In 1948, 52.4 per cent of governmental revenue was raised through individual and corporate income taxes; in 1942, 35.3 per cent. Corresponding percentages for the Federal Government (by which an increasing proportion of governmental expenditure will be financed in the future) are: 1948, 70.7; 1942, 58.6. See U. S. Bureau of the Census, *Governmental Revenue in 1948*, p. 9; R. A. Musgrave and Tun Thin, " Income Tax Progression, 1929-48," *Journal of Political Economy*, LVI (1948), 498 ff.

[46] See K. E. Boulding, " The Incidence of a Profits Tax," *American Economic Review*, XXXIV (1944), 567-72. Boulding rests his supposition that the supply of enterprise is positive upon M. Kalecki's " prin-

The upshot of the discussion in this section is that the rate of growth of national income will be depressed by the tax-connected income transfers associated with expanding taxation. The recipients of these transfers will reduce the amount of work they put forth. This reduction will not be compensated and will probably be accentuated by the response of the suppliers of these income transfers to their increase.

V. CONCLUSIONS

In section I it was revealed that in consequence of the gradual cessation of population growth, the national income would grow much less rapidly than in the past. In section II it was shown that public expenditures would continue to grow more rapidly than national income, since the latter's rate of growth was falling whilst the former's was being sustained if not increased by the rise to power of vast free-income-seeking political pressure groups. In section III it was indicated that when the limits of taxable capacity have been reached, the forces of inflation get the upper hand. In section IV it was shown that the tax-connected transfers will themselves act to depress the rate at which the national income grows. The major conclusion that follows from our examination of the data is that in all probability because of circumstances operating in the political sphere, the long-run trend in prices will be upward.

This conclusion, if valid, is of great practical significance for the private non-bank saver and investor. It means that both private and governmental fixed-income securities will prove poor investments unless guarded by a clause defining income in term of dollars of constant purchasing power. It means that annuities will offer much less security than their purchasers had anticipated. It means that equities will became comparatively more attractive. It means that the investment-trust approach will appeal in increasing degree to the small saver.

Our main conclusion, while probable, is not certain. Its realization may be averted in several ways. (a) Given an unprecedentedly high rate of increase

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ciple of increasing risk " (cf. his *Essays in the Theory of Economic Fluctuations* [London: George Allen & Unwin, Ltd., 1939]); and O. von Mering, *The Shifting and Incidence of Taxation* (Philadelphia: Blakiston Co., 1942), chaps. 6, 12-13. P. D. Bradley shows that both a profits tax and an income tax may cause the taxed subject to behave in such a way as to reduce the rate at which his income grows. See his " The Direct Effects of a Corporate Income Tax," *Quarterly Journal of Economics*, LVI (1942), 638-54, and " Some Effects of the Personal Income Tax," *ibid.*, LVIII (1943), 134-40. Domar and Musgrave (*op. cit.*) have shown how a system of loss offsets can increase the supply of private risk-taking. Aspects of the problem here under discussion have been treated by Meade, *op. cit.*; A. Lerner, *Economics of Control* (New York: Macmillan Co., 1944), chap. 19. Relevant welfare aspects of types of taxes are treated by G. A. D. Preinreich, " Progressive Taxation and Sacrifice," *American Economic Review*, XXXVIII (1948), 103-17; and E. R. Rolph and G. F. Break, " The Welfare Aspects of Excise Taxes," *Journal of Political Economy*, LVIII (1949), 46-54. On the role of incentive with respect to the business executive see R. A. Gordon, *Business Leadership in the Large Corporation* (Washington, 1945), chap. 12, and C. I. Barnard, *The Functions of the Executive* (Cambridge: Harvard Press, 1938), chap. 11; cf. Z. C. Dickinson, *Economic Motives* (Cambridge: Harvard Press, 1922), chap. 19. S. E. Harris considers the incidence of social security taxes in his *Economics of Social Security* (New York: McGraw-Hill Book Co., 1941), Part III. See also Sam Arnold, " Forward Shifting of a Payroll Tax under Monopolistic Competition," *Quarterly Journal of Economics*, LXI (1947), 267 ff. The case for direct as against indirect taxation has been effectively stated by A. Henderson, " The Case for Indirect Taxation," *Economic Journal*, LVIII (1948), 538-53.

in national income, governmental expenditure may lag behind. This solution, however, is unlikely. (b) Governmental expenditure may be restricted by curtailing the growth of free-income disbursals to pressure groups. This solution may be achieved in effect if the rate of growth of aggregate public expenditure is made to depend for some decades upon that of per capita income. Accomplishment of this objective is rendered somewhat difficult, however, by the fact that the rate of growth of public expenditure is affected by that of both per capita income *and* population. (c) Institutional and other changes may be introduced to raise the ceiling value of the ratio above its present level, 25 per cent or whatever it happens to be. This can be accomplished by changing the tax structure, by modifying the composition of governmental expenditure, and by altering the esteem in which the taxpayer holds the items with which tax revenue supplies him and the community.

It has been indicated that the demand for security is operating more than any other factor to expand public expenditure faster than national income. This same demand is operating in the private sector to produce either inflation, or an inequitable distribution of privately financed security. Because the struggle for mass security is being conducted on two fronts, because what is sought on one front is partly conditioned by what is provided on the other, because an imperfect consolidation of these two-front demands inflates the amount of security requested beyond what the economy can provide, and because mass security can be more effectively provided by one agency than by another, the bulk of mass security should be administered by that agency which is most suited to administer it. If, as most students believe, this is the state, then the state and not, as is now being demanded, private industry, should provide security, with the individual beneficiary paying most of the bill. If this course is not chosen, and the present two-front struggle is permitted to continue, the inflation-generating forces described in this paper will be magnified.[47]

[47] I am indebted to my colleagues, Professors B. U. Ratchford and E. C. Simmons, for helpful suggestions.

DEVISING A RATE STRUCTURE FOR THE CITY BUSINESS TAX

JAMES W. MARTIN and MARY EVINS *

IN MANY CITIES license taxes are imposed on numerous types of business enterprise. If a retail clothing merchant having a $40,000 annual turnover were situated in one of the cities which imposes a flat-rate license on such merchants, he would pay the same tax as another clothing merchant having a gross annual turnover of $4 million, or 100 times as much in relation to sales. Although this is grossly discriminatory in view of the difference in volume of business, the pattern is quite usual in practice. Reduction of such crudity is essential if considerable revenue is to be derived from local business taxation.

THE GROSS RECEIPTS TAX

The discrimination just described is being displaced in some cities by means of a tax based on gross receipts.[1] The use of this measure simplifies the structure of the ordinance and ties the amount of tax to be paid by an individual concern to the volume of business more successfully than do the other bases of license taxes now in common use. A possible serious objection to this basis for the imposition of license taxes, however, is that the amount of tax due is not related to the varying margins of profit among the different kinds of business. Thus, a retail meat store which in Kentucky has an average profit margin of 15 per cent, a florist's shop which has an average profit margin of 49 per cent, and a real estate agency which has a profit margin of 91 per cent might all be called on to pay the same proportion of gross receipts. Such a requirement would demand that the meat seller, in the case of a 1 per cent tax, pay 1/15 of his gross profit; a florist, 1/49; and a real estate agency, 1/91. These figures imply a discriminatory tax policy which would normally prove objectionable (a) to concerns engaged in low-profit-margin businesses and (b) to social-minded persons who dislike requiring a greater tax on cost-of-living items, such as are characteristically within the class normally having narrow margins of profit.

As such business taxes have become more prevalent, various efforts have been made to introduce refinements in the interest of equity. Among the proposals made are those for measuring liability by net income, by gross profits, or by some approximation of one or the other of these bases, depending upon the guiding social philosophy.

A basis of taxing businesses which is more equitable than a flat-rate gross receipts plan would seem to be either gross profits or net income.[2] How-

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[1] International City Managers' Association, *Administration of Business Gross Receipts Taxes* (Chicago, 1948).

[2] Such bases of taxation would tend to take into account the volume or profitableness of the taxpayer's business. The Federal and many state corporation income tax programs are based on substantially the

ever, neither of these bases has had extended use, mainly because of the difficulty of administration both from the standpoint of the local government and from that of the taxpayer.

The same result, however, could be approximated by a carefully designed gross receipts tax. Such a gross receipts tax would be imposed at different rates on different classes of business in order to make allowance for varying relationships between gross receipts and gross profits or net income. The tax paid by any particular taxpayer would be based on gross receipts rather than on his individual gross profits or net income, but the tax rate would reflect the relationship between gross receipts and gross profits or net income characteristic of the taxpayer's class of business. As applied to a particular business firm, the modified gross receipts tax would not impose the same liability as a tax based directly on gross profits or net income; but, as applied to a whole class of business or to the average firm in a class, the gross receipts tax would produce substantially the same results as a tax on gross profits or net income. Thus the modified gross receipts tax could substantially eliminate the discrimination among whole classes of business that occurs under a uniform-rate gross receipts tax and could reduce, but not eliminate, the discrimination among individual firms in any one class of business.

GROSS PROFITS MEASURE

One method of arriving at rates based on gross profits but measured by gross receipts is to establish normal or representative profit margins for various types of business. The procedure then is to use profit-margin figures and apply multipliers necessary to raise the desired amount of revenue and in this manner to establish rates for the various types of businesses.

According to this method, Table 1 has been computed, making use of data pertaining to Kentucky businesses. The data for the table consist of statistics compiled from about 6,400 of the 1947 Kentucky State income tax returns, excluding altogether reports indicating no tax liability.[3]

Terminology

The idea of gross receipts is the same as that used for Kentucky State income taxation. It includes net sales of inventory added to any receipts from salaries, wages, commissions, rents, royalties, interest, dividends, and other sources. Unfortunately for greater refinement, it was impossible to obtain a complete separation between the gross receipts from business and those from other sources. However, review of a considerable number of returns for which such separation could be made suggests that the use of general, rather than operating, data makes little difference in the relationships reflected in the ratios of gross profits and net income to gross receipts.

An attempt was made to arrive at a figure for gross profits in line with ordinary business usage. In some cases

same line of reasoning. The idea of a gross profits base of business taxation is roughly similar to the "value added" measure for business taxation, which has been widely accepted as the fairest method of taxing business.

[3] Also excluded as far as practicable are mixed businesses. For these some specific provision would need to be made in an ordinance. The usual practice in the cities known to the writers in which a kindred plan has been adopted has included authorization of separate accounting or taxation at the highest rate applicable at the option of the taxpayer.

TABLE 1

Illustrative Gross Receipts License Rates Computed from Ratios of Gross Profits to Gross Receipts: Sample of Kentucky Income Tax Returns, 1947

Class of Business	Ratio of Gross Profits to Gross Receipts	Alternative Rate Possibilities	
		Higher Rate	Lower Rate
Public utilities other than transport	73%	0.7%	0.4%
Transportation and allied services	**73**	**0.7**	**0.4**
Trucking and warehousing for hire	100	1.0	0.5
Services allied to transportation, not elsewhere listed	43	0.4	0.2
Other transportation	100	1.0	0.5
Contract construction	**24**	**0.2**	**0.1**
Building construction—general contractors	18	0.2	0.1
Construction—special-trade contractors	28	0.3	0.1
General contractors, other than building	23	0.2	0.1
Finance, insurance, and real estate	**95**	**1.0**	**0.5**
Finance agencies, not elsewhere classified	100	1.0	0.5
Insurance agents, brokers, and other services	93	0.9	0.5
Real estate	91	0.9	0.5
Real estate, insurance, loans, law offices: any combination	100	1.0	0.5
Security dealers and investment banking	98	1.0	0.5
Manufacturing	**27**	**0.3**	**0.1**
Apparel	28	0.3	0.1
Bakery	27	0.3	0.1
Chemicals and allied products	26	0.3	0.1
Food and kindred products	31	0.3	0.2
Furniture and finished lumber products	26	0.3	0.1
Iron and steel and their products	29	0.3	0.1
Lumber and timber basic products	24	0.2	0.1
Nonferrous metals and their products	28	0.3	0.1
Printing, publishing, and allied industries	24	0.2	0.1
Stone, clay, and glass products	36	0.4	0.2
Other manufacturing	26	0.3	0.1
Mining	**25**	**0.2**	**0.1**
Coal mining	21	0.2	0.1
Crude-petroleum and natural-gas production	24	0.2	0.1
Other mining and quarrying	39	0.4	0.2
Retail trade	**28**	**0.3**	**0.1**
Apparel and accessories	32	0.3	0.2
Automotive	30	0.3	0.1
Bakeries	41	0.4	0.2
Coal and coke dealers	31	0.3	0.2
Dairies	34	0.3	0.2
Druggists	28	0.3	0.1
Eating and drinking places	49	0.5	0.2
Feed, grain, hay, seed, etc.	14	0.1	0.1
Filling stations	22	0.2	0.1
Florists and nurseries	49	0.5	0.2
Furniture	38	0.4	0.2
General merchandise; department stores	31	0.3	0.2
Green groceries	21	0.2	0.1
Groceries (general)	15	0.2	0.1
Hardware	28	0.3	0.1
Household appliances	47	0.5	0.2
Liquor stores	19	0.2	0.1
Lumber and other building materials	22	0.2	0.1
Meat and produce	15	0.2	0.1
Other retail trade	36	0.4	0.2

TABLE 1—(*Continued*)

Class of Business	Ratio of Gross Profits to Gross Receipts	Alternative Rate Possibilities	
		Higher Rate	Lower Rate
Service	90%	0.9%	0.4%
Amusement, recreation, and related services	99	1.0	0.5
Automobile repair services and garages	38	0.4	0.2
Business services, not elsewhere classified	71	0.7	0.4
Employment agencies, commercial and trade schools	99	1.0	0.5
Hotels, rooming houses, camps, other lodging places	74	0.7	0.4
Laundries, dyers, dry cleaners	98	1.0	0.5
Law offices and related services	100	1.0	0.5
Medical and other health services	96	1.0	0.5
Miscellaneous repair services and hand trades	55	0.6	0.3
Motion pictures	95	1.0	0.5
Personal services	88	0.9	0.4
Other professional and social-service agencies	100	1.0	0.5
Professions other than law or medical	99	1.0	0.5
Wholesale trade	24	0.2	0.1
Commission and merchandise brokers	81	0.8	0.4
Grocery (general)	12	0.1	0.1
Liquor	27	0.3	0.1
Meat and produce	13	0.1	0.1
Tobacco	11	0.1	0.1
Other wholesale trade	28	0.3	0.1

it was impossible to do this because of the limitations of available data. However, the gross profits concept was defined in such a manner as to arrive at figures which would be substantially uniform for the various classes of business. (See appendix for more detailed information.)

Methodology

The method used in computing the various ratios was to divide the sum of the dollar figures for gross profits by the sum of the dollar figures for gross receipts. The ratio arrived at by this procedure is a weighted average rather than an average of percentages. If the approach employed had been to obtain an average of the individual percentages, the resulting ratio might have been unduly influenced by the ratio for small individual firms.

All figures shown in the table were compiled from a sample of at least ten businesses. The figures for the classes of business for which ten cases were not available are included under the category " other."

When these ratios are all multiplied by the same number, the desired relationship among the various classes of business is maintained. The multipliers used to produce the illustrative rates were 1 per cent for the higher rate, and 0.5 per cent for the lower rate. These are merely two possible levels of rates which might be applied. The actual rate should be determined by the amount of revenue desired from this method of taxation. Thus, the larger the amount of revenue to be raised by taxes on business, the higher will be the multiplier used.

Table 1 has purposely been constructed to show classes of business in as much detail as possible using the data available. It contains a ratio for every class of business for which at least ten

TABLE 2

ILLUSTRATIVE GROSS RECEIPTS LICENSE RATES COMPUTED FROM RATIOS OF NET INCOME TO GROSS RECEIPTS: SAMPLE OF KENTUCKY INCOME TAX RETURNS, 1947

Class of Business	Ratio of Net Income to Gross Receipts	Alternative Rate Possibilities	
		Higher Rate	Lower Rate
Public utilities other than transport	31%	0.9%	0.3%
Transportation and allied services	**11**	**0.3**	**0.1**
Trucking and warehousing for hire	13	0.4	0.1
Services allied to transportation, not elsewhere listed	6	0.2	0.1
Other transportation	20	0.6	0.2
Contract construction	**13**	**0.4**	**0.1**
Building construction—general contractors	10	0.3	0.1
Construction—special-trade contractors	15	0.4	0.2
General contractors, other than building	13	0.4	0.1
Finance, insurance, and real estate	**42**	**1.3**	**0.4**
Finance agencies, not elsewhere classified	33	1.0	0.3
Insurance agents, brokers, and other services	34	1.0	0.3
Real estate	46	1.4	0.5
Real estate, insurance, loans, law offices: any combination	46	1.4	0.5
Security dealers and investment banking	53	1.6	0.5
Manufacturing	**13**	**0.4**	**0.1**
Apparel	13	0.4	0.1
Bakery	7	0.2	0.1
Chemicals and allied products	9	0.3	0.1
Food and kindred products	14	0.4	0.1
Furniture and finished lumber products	10	0.3	0.1
Iron and steel and their products	14	0.4	0.1
Lumber and timber basic products	10	0.3	0.1
Nonferrous metals and their products	14	0.4	0.1
Printing, publishing, and allied industries	13	0.4	0.1
Stone, clay, and glass products	11	0.3	0.1
Other manufacturing	15	0.4	0.2
Mining	**15**	**0.4**	**0.2**
Coal mining	13	0.4	0.1
Crude-petroleum and natural-gas production	13	0.4	0.1
Other mining and quarrying	24	0.7	0.2
Retail trade	**9**	**0.3**	**0.1**
Apparel and accessories	8	0.2	0.1
Automotive	12	0.4	0.1
Bakeries	13	0.4	0.1
Coal and coke dealers	8	0.2	0.1
Dairies	6	0.2	0.1
Druggists	10	0.3	0.1
Eating and drinking places	11	0.3	0.1
Feed, grain, hay, seed, etc.	4	0.1	0.05
Filling stations	9	0.3	0.1
Florists and nurseries	15	0.4	0.2
Furniture	14	0.4	0.1
General merchandise; department stores	10	0.3	0.1
Green groceries	8	0.2	0.1
Groceries (general)	4	0.1	0.05
Hardware	12	0.4	0.1
Household appliances	16	0.5	0.2
Liquor stores	10	0.3	0.1
Lumber and other building materials	10	0.3	0.1
Meat and produce	6	0.2	0.1
Other retail trade	12	0.4	0.1

TABLE 2—(*Continued*)

Class of Business	Ratio of Net Income to Gross Receipts	Alternative Rate Possibilities	
		Higher Rate	Lower Rate
Service	**21%**	**0.6%**	**0.2%**
Amusement, recreation, and related services	20	0.6	0.2
Automobile repair services and garages	11	0.3	0.1
Business services, not elsewhere classified	24	0.7	0.2
Employment agencies, commercial and trade schools	28	0.8	0.3
Hotels, rooming houses, camps, other lodging places	23	0.7	0.2
Laundries, dyers, dry cleaners	14	0.4	0.1
Law offices and related services	73	2.2	0.7
Medical and other health services	61	1.8	0.6
Miscellaneous repair services and hand trades	16	0.5	0.2
Motion pictures	29	0.9	0.3
Personal services	32	1.0	0.3
Other professional and social-service agencies	27	0.8	0.3
Professions other than law or medical	6	0.2	0.1
Wholesale trade	**8**	**0.2**	**0.1**
Commission and merchandise brokers	16	0.5	0.2
Grocery (general)	2	0.1	0.05
Liquor	6	0.2	0.1
Meat and produce	4	0.1	0.05
Tobacco	2	0.1	0.05
Other wholesale trade	9	0.3	0.1

groups of figures were available. However, it might be desirable to simplify a tax structure of this type by using, in some instances, the bold-face figures which are a composite of the more detailed figures following and which represent the average of the specific classes. For example, the detailed ratios listed under finance, insurance, and real estate are so nearly alike that for the sake of simplification of administration it might be well to eliminate the separate listings of finance agencies, insurance agents, real estate agents, security dealers, etc., from the tax structure.

Obviously, the degree of dispersion of the data, which would affect the conformity of the rates with the gross profits of the individual concern, would depend on the detail with which a type-of-business breakdown is made in the first instance. Except for the few " miscellaneous " businesses shown in Table 1, the rate based on the detailed figures would fail in comparatively few cases to be the " proper " rate from the viewpoint of individual taxpayers, unless the rate structure were designed to produce more revenue than is currently done in cities which have approximated the suggested plan.[4] Moreover, although the data for the present study were assembled for only one year, the information available from scattered other sources suggests that the ratios for the various classes of businesses would remain fairly stable over a number of years.

NET INCOME MEASURE

Similar computations may be made using data for net income instead of gross profits, as shown in Table 2. However, the ratios of net income to gross receipts for the individual business will

[4] The assembled data are being subjected to detailed scrutiny for separate publication of an accurate assessment of the problem of dispersion—as well as other technical statistical characteristics.

TABLE 3

RATIOS OF GROSS PROFITS TO GROSS RECEIPTS OF KENTUCKY BUSINESSES BY GENERAL CHARACTER OF BUSINESS AND SIZE OF CITY: SAMPLE OF KENTUCKY INCOME TAX RETURNS, 1947

Class of Business	State Ratio: All Cities	Ratio for Cities of— 1st Class	2nd Class	3rd Class	4th Class and Smaller
Public utilities other than transport	73%	...	...	...	...
Transportation and allied services	**73**	**100%**	**41%**	**100%**	**100%**
Trucking and warehousing for hire	100	100	100	100	...
Services allied to transportation, not elsewhere listed	43	100	...	...	...
Other transportation	100	...	27	...	100
Contract construction	**24**	**25**	**27**	**17**	**42**
Building construction—general contractors	18	20	24	...	...
Construction—special-trade contractors	28	28	33	...	...
General contractors, other than building	23	23	22	...	...
Finance, insurance, and real estate	**95**	**95**	**96**	**100**	**97**
Finance agencies, not elsewhere classified	100	100	...	...	...
Insurance agents, brokers, and other services	93	92	92	100	100
Real estate	91	89	97	99	92
Real estate, insurance, loans, law offices: any combination	100	100	100	100	100
Manufacturing	**27**	**28**	**21**	**19**	**30**
Bakery	27	28	...	...	...
Chemicals and allied products	26	24	...	...	...
Food and kindred products	31	32	28	...	24
Furniture and finished lumber products	26	31	...	...	...
Iron and steel and their products	29	31	26	...	...
Lumber and timber basic products	24	25	...	...	33
Printing, publishing, and allied industries	24	22	36	...	52
Other manufacturing	27	30	19	19	30
Mining	**25**	**23**	**32**	...	**23**
Coal mining	21	...	...	...	21
Other mining	30	...	...	...	40
Retail trade	**28**	**30**	**27**	**24**	**24**
Apparel and accessories	32	34	30	27	29
Automotive	30	35	26	24	25
Bakeries	41	40	...	...	...
Coal and coke dealers	31	29	...	...	...
Dairies	34	...	34	...	...
Druggists	28	27	28	27	29
Eating and drinking places	49	56	37	27	37
Filling stations	22	22	22	...	...
Florists and nurseries	49	44	53	...	...
Furniture	38	42	37	37	30
General merchandise; department stores	31	30	35	31	28
Grocery (general)	15	15	15	14	14
Hardware	28	32	28	26	25
Household appliances	47	56	31	...	...
Liquor stores	19	21	18	21	16
Lumber and other building materials	22	19	24	...	28
Meat and produce	15	17	12	...	...
Other retail trade	32	33	31	27	32
Service	**90**	**94**	**80**	**80**	**78**
Amusement, recreation, and related services	99	100	99	93	100
Automobile repair services and garages	38	39	38	32	39
Business services, not elsewhere classified	71	72	66	77	79
Employment agencies, commercial and trade schools	99	97	...	...	...

TABLE 3—(*Continued*)

Class of Business	State Ratio: All Cities	Ratio for Cities of— 1st Class	2nd Class	3rd Class	4th Class and Smaller
Service—(*Continued*)					
Hotels, rooming houses, camps, other lodging places	74%	68%	82%	...	89%
Laundries, dyers, dry cleaners	98	97	100	...	100
Law offices and related services	100	100	100	100%	100
Medical and other health services	96	96	96	97	97
Miscellaneous repair services and hand trades	55	64	55	...	45
Motion pictures	95	100	...	...	...
Personal services	88	94	81	100	86
Professions other than law or medical and other professional and social-service agencies	99	100	88	77	97
Wholesale trade	**24**	**29**	**21**	**14**	**16**
Commission and merchandise brokers	81	72	100	100	100
Grocery (general)	12	16	8	...	...
Meat and produce	13	14	14	...	...
Other wholesale trade	26	30	22	12	16

vary widely from the average ratio for the class. The gross profits measure, although it shows some such variations, does not differ from business to business within a class nearly as much as does the net income measure. Moreover, there is good reason from the evidence at hand to think that the net income measure would require revision, at least in depression as compared with prosperous years; but the data assembled for the present study do not test this hypothesis.

Terminology

"Net income," as the term is here employed, does not have precisely the same meaning as in accounting parlance. However, it is as close to this concept as can be secured from income tax reports. Specifically, it means net taxable income plus interest paid, taxes (which are not an outright cost), donations to charities, casualty deductions, and such capital losses as have been deducted. From this figure taxable capital gains were deducted. These readjustments, which bring the net income figure into rough conformity with the accounting concept of income before interest or income taxes, were necessary in order to place all businesses of a class on about the same basis.

Methodology

The method used to formulate Table 2 was the same as that described for Table 1, except that net income replaced gross profits. However, in making use of the ratios in the first column the factor used in multiplying would be higher than that employed in the case of the gross profits figures to obtain the same amount of revenue. In Table 2, illustrative rates of 1 and 3 per cent of the ratio were used, subject to the limitation that the minimum tax rate should be 0.05 per cent.

USE OF MORE LOCALIZED DATA

More detailed analysis of data for development of ratios than that presented above might be used. For instance,

TABLE 4

Ratios of Net Income to Gross Receipts of Kentucky Businesses by General Character of Business and Size of City: Sample of Kentucky Income Tax Returns, 1947

Class of Business	State Ratio: All Cities	Ratio for Cities of— 1st Class	2nd Class	3rd Class	4th Class and Smaller
Public utilities other than transport	31%	..	..	..	..
Transportation and allied services	**11**	**13%**	**7%**	**20%**	**19%**
Trucking and warehousing for hire	13	12	13	23	..
Services allied to transportation, not elsewhere listed	6	12	..	..	..
Other transportation	20	..	6	..	19
Contract construction	**13**	**12**	**11**	**14**	**25**
Building construction—general contractors	10	11	10	..	..
Construction—special-trade contractors	15	13	11	..	..
General contractors, other than building	13	11	12	..	..
Finance, insurance, and real estate	**42**	**39**	**47**	**55**	**55**
Finance agencies, not elsewhere classified	33	33	..	..	..
Insurance agents, brokers, and other services	34	28	35	52	56
Real estate	46	44	51	60	56
Real estate, insurance, loans, law offices: any combination	46	42	55	56	61
Manufacturing	**13**	**12**	**11**	**11**	**16**
Bakery	7	7	..	..	..
Chemicals and allied products	9	9	..	..	..
Food and kindred products	14	13	15	..	12
Furniture and finished lumber products	10	11	..	..	..
Iron and steel and their products	14	16	12	..	..
Lumber and timber basic products	10	10	..	..	22
Printing, publishing, and allied industries	13	12	22	..	23
Other manufacturing	14	14	11	11	16
Mining	**15**	**15**	**17**	..	**15**
Coal mining	13	..	..	..	14
Other mining	18	..	..	..	31
Retail trade	**9**	**10**	**9**	**9**	**9**
Apparel and accessories	8	9	7	5	6
Automotive	12	14	10	11	11
Bakeries	13	16	..	..	..
Coal and coke dealers	8	6	..	..	..
Dairies	6	..	6	..	..
Druggists	10	11	9	12	12
Eating and drinking places	11	10	12	11	10
Filling stations	9	10	8	..	..
Florists and nurseries	15	11	14	..	..
Furniture	14	17	12	13	12
General merchandise; department stores	10	8	12	11	11
Grocery (general)	4	4	4	3	3
Hardware	12	11	12	16	13
Household appliances	16	19	12	..	..
Liquor stores	10	11	9	11	8
Lumber and other building materials	10	10	10	..	10
Meat and produce	6	8	5	..	..
Other retail trade	10	10	11	11	10
Service	**21**	**17**	**30**	**29**	**32**
Amusement, recreation, and related services	20	20	20	20	34
Automobile repair services and garages	11	14	9	12	11
Business services, not elsewhere classified	24	21	29	25	25
Employment agencies, commercial and trade schools	28	19	..	..	..

TABLE 4—(*Continued*)

Class of Business	State Ratio: All Cities	Ratio for Cities of— 1st Class	2nd Class	3rd Class	4th Class and Smaller
Service—(*Continued*)					
Hotels, rooming houses, camps, other lodging places	23%	29%	15%	..	19%
Laundries, dyers, dry cleaners	14	11	19	..	21
Law offices and related services	73	72	73	76%	76
Medical and other health services	61	63	62	56	55
Miscellaneous repair services and hand trades	16	17	18	..	11
Motion pictures	29	31	..	..	..
Personal services	32	30	34	33	34
Professions other than law or medical and other professional and social-service agencies	6	5	29	24	37
Wholesale trade	8	8	7	7	7
Commission and merchandise brokers	16	13	16	52	30
Grocery (general)	2	2	3	..	..
Meat and produce	4	3	5	..	..
Other wholesale trade	9	9	10	6	6

Kentucky cities are divided according to population into first-class cities, having a population of 100,000 or more; second-class cities, having a population of 20,000 or more; third-class cities, having a population of 8,000 or more; and all other cities are classified legally as fourth-, fifth-, or sixth-class cities. Classification of the data according to class of city, using gross profits measures, is presented in Table 3. Table 4 shows a similar tabulation using the net income measure.

This method of presentation reduces the reliability of the data by reducing the number of concerns in the sample available for each type of business. It also prevents the use of as detailed a breakdown as that employed in Tables 1 and 2. However, it has the advantage of reflection of possible change in gross profits and net income ratios attributable to the size of the city.

To make use of Table 3 or Table 4 the appropriate column should be enlarged into a table similar to Table 1 or Table 2. Each column in Table 3 and Table 4 is presented in as much detail as is permitted by available data. If a more detailed breakdown is needed for a particular city, use could be made of the state figure for that particular class of business. For example, if a third- or fourth-class city considered it necessary to have a distinct figure for retail bakeries, it could use the state figure, since no local figure is available for that class.

If even more localized ratios were desired, data are available in Kentucky for making tables for the larger individual cities using data from businesses in those cities. Indeed, the figures for cities of the first class are really data for one city, for Louisville is the only city falling in this category. A table of this sort for any city in Kentucky except Louisville, however, would need to be supplemented with figures for the particular class of city or for the State as a whole if a detailed breakdown by type of business were desired.

CONCLUSION

Tables used in this paper have made use of data pertaining to Kentucky. These tables are suggestive of similar tables making use of data pertaining to other state or local governments. Of course, Kentucky figures could be used elsewhere if they are deemed to be sufficiently representative to justify such use in another state. These statistics applied elsewhere would certainly be an improvement over the guesses sometimes employed.

APPENDIX

The concept of gross profits inevitably varies somewhat in the different classes of business. The limitations of the data dictated these unfortunate variations in order to maintain uniformity in each particular class of business.

Deductions from gross receipts to arrive at gross profits from the construction business included operating labor on the job; depreciation of machinery or tools on the job; cost of goods, including freight in; social security taxes; and insurance premiums. Overhead and office expenses were not deducted.

In the instance of finance, insurance, and real estate concerns, the only sizable deductions were cost of utility services for rental business.

For manufacturing, the principle was the same as for construction. Depreciation on buildings used in processing was deducted. Social security and property taxes due to labor or property used in manufacturing processes were deducted (if leased, the rental was deducted). Factory repairs were deducted.

In the case of public service companies engaged in transportation or distribution only, no deductions from gross receipts were taken except for cost of electric current, gas, and the like. If the public utility manufactured electricity or other products the same deductions from gross receipts were taken as in other manufacturing.

For mining, deductions followed the pattern for construction. Depletion was also subtracted.

The cost of goods sold, including inbound freight, was deducted from the gross receipts of service, retailing, and wholesaling concerns. In the case of service concerns the general policy of making deductions for commodities ultimately sold, but not for supplies, was followed even when supplies bulked large and inventory not very large. Thus laundries, dyers, and cleaners had no deduction for cleansing agents; automobile repair shops, none for supplies; doctors and dentists, none for tools and office supplies and equipment. Automobile repair shops did have deducted the cost of the parts they purchased; physicians, the artificial limbs they bought for resale; and dentists, gold for fillings and false teeth they procured.

RECENT DEVELOPMENTS IN CORPORATE TAXATION IN CANADA

A. KENNETH EATON *

NEW LAW for taxing corporate profits recently passed by the Canadian Parliament contains certain features which will be of interest in the United States, not only to professionals in the tax field but also to taxpayers generally.

After years of discussion on this continent about the so-called double taxation problem to an extent that undoubtedly would have led Mark Twain to include this item along with the weather in deploring the lack of action by the public, Canada has done something about it. What has been done, and some of the problems encountered in doing it, will be outlined here. Certain other significant changes in the corporate tax picture in Canada will likewise be analysed.

10 Per Cent Tax Credit for Dividends Received

Hereafter, in computing income tax, individuals residing in Canada may deduct from their tax bill an amount equal to 10 per cent of the net dividend income they receive in the year from Canadian taxpaying corporations. This, in brief, sums up Canada's first step toward removing double taxation.

Obviously there are two general methods of approach in removing double taxation of corporate profits. One approach leads to the elimination of the corporation tax on distributed income, leaving the personal income tax as the sole tax applying to dividends. The other general approach would call for removing in whole or in part the personal income tax on dividends, leaving the corporate levy intact.

The first of these objectives could be accomplished in several ways. For example, corporations could be allowed a deduction equal to dividends paid out so that the corporation tax would be merely an undistributed-profits tax, or tax could be paid by the corporation on total profits with corresponding refunds or offsets for the shareholder. The latter is the case in the United Kingdom.

The alternative general approach could lead to the exclusion of dividend income entirely from personal income tax. Some countries do this. Clearly, however, such a system is open to criticism. The objective of removing double tax can be achieved in a less drastic manner by the tax-credit device while leaving dividends still to be included in income for purposes of personal income tax at graduated rates.

Differing sets of problems arise under the two general approaches to a solution. Under what might be called the British system (falling under the first approach) the tax paid by the corporation is, at least in respect of distributed income, merely a deduction of tax at the source. Accordingly, under this system the taxpayer is required to

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" gross up " the dividends he receives in reporting his income, that is, he must take into income not merely the dividend actually received but also the tax withheld by the corporation and paid over to the Treasury. This simply corresponds to the practice in the United States and Canada which requires a salaried man to report his full salary and not merely the cash received after his employer has deducted tax at the source. " Grossing up " may not be a complex matter at all in the United Kingdom where there is a standard rate of tax and where the dividend actually declared is the gross amount, the corporation accounting to the shareholder by sending him a check for the dividend declared, less tax. It would not, however, be quite so simple a matter in either Canada or the United States to require taxpayers to " gross up " their dividends, that is, to report having received an amount of income which, after being reduced by an amount equal to the tax paid by the corporation on that much income, would leave a sum equal to the cash dividend actually received. Still less would this procedure be understood by all if it should be decided that, as a first step, only part of the double tax would be eliminated.

If the first approach is accepted, under which the corporation tax is treated as a deduction at the source, then logic would appear to compel the granting of refunds to persons who have no income tax liability. This would arise because they are statutorily exempt, because their income is below the exemption levels or because their tax liability is less than the amount deducted or deemed to have been deducted at the source. On the other hand, if the second approach is followed, whereby the objective is the abatement of personal income tax up to the amount of the corporation tax, then there is no case for refunds to exempt persons. The taxpayer would only be entitled to a tax credit up to the amount of additional tax payable as a result of having received the dividend. For example, a taxpayer may have incurred certain expenses properly chargeable against the dividend income such as interest on borrowed money. Clearly then it is only the tax on the net amount of dividend which should qualify for the tax credit.

After reviewing the implications of the two systems Canada adopted the second approach, namely, that of abating personal income tax on net dividend income to the extent measured by 10 per cent of such net dividend received. This method of removing double tax is simpler, both for the taxpayer and the administration, and is considerably less costly in revenue loss than the alternative system.

The 10 per cent tax credit is confined to dividends from corporations residing in Canada and is allowed only if they are subject to the corporation income tax. (Certain investment companies, for example, may be exempt from corporation tax, and while exempt their dividends are ineligible for the tax credit.) It was of course recognized that some resident corporations may earn practically all their income abroad, paying corporate tax thereon to a foreign government (and receiving an offset against Canadian tax), while many nonresident companies may derive a great part of their income from Canada, either through branch operations or subsidiary companies. To look through the corporate structure and apportion the tax credit on the basis of

income subject to Canadian corporate tax would have been too difficult and accordingly the single criterion of residence was adopted. If, in the future, a credit is allowed in the United States along lines somewhat similar to that granted in Canada then the question of each country's allowing a credit on dividends from the other country would appear to be an appropriate subject for treatment under an international tax convention.

The most difficult point of principle encountered in connection with the tax credit was whether it should be confined to dividends from shares having no preference of any kind or whether all dividends should qualify. As originally announced by the Canadian Minister of Finance on March 22, 1949, a credit was not to be granted in respect of shares that enjoyed any special preference. "Generally speaking," the Minister stated, "the incidence of the corporation tax is upon the common shareholder and I believe that they rather than preferred shareholders should be granted such relief as can be given at this time." Nearly eight months later, however, when the legislation was actually introduced in Parliament the decision had been reached to allow all dividends to qualify for the tax credit.

This broadening of the credit to include all dividends may be held by some to be indefensible upon what might be called purely theoretical grounds. One should be quite clear, however, as to the purpose of the tax credit before deciding whether the pattern followed is logical or not.

If the purpose is to remove double taxation in a purely technical sense, or to achieve greater equity in the tax system as a whole for the shareholder, then there may be a valid objection to preferred shareholders' being given a tax credit. If, however, without being primarily concerned about the position of the shareholder from the point of view of equity, the main consideration is encouragement to the flow of capital into industry, then there are not the same grounds for a distinction between various classes of shares. A tax credit as an incentive measure might be in order even if there were no double taxation. Likewise a tax credit to remove double taxation could be reasonably granted even though the flow of capital into industry were quite satisfactory.

In explaining the purpose of the tax credit to the Canadian House of Commons the Minister of Finance said: "Today we find governments in this country as well as in most other countries, taxing away at least a third of corporate profits. In addition, the personal income tax rates apply in full to what is distributed out of the remaining two-thirds. The tax may be as high as 80 per cent upon distributions to shareholders. It seems to me that under a system of private enterprise which depends for its existence on a steady flow of venture capital we cannot afford to neglect the implications of this defect in our tax system which has been accentuated by the increase in both corporate and personal income tax rates. . . . It is not a question of the immediate profit position of Canadian business because I think it is clear that today we in Canada are prosperous as never before. Rather it is a matter of concern for the future under a system where we depend, and must depend, for full employment and the creation of new wealth on the willingness of our people to risk their money in constructive

enterprises." It seems clear from the quotation above that the Minister of Finance cannot be charged with inconsistency in allowing the tax credit to preferred shareholders in view of the emphasis on encouraging the flow of funds into industry.

To confine the tax credit to those who bear the incidence of the corporation tax is no easy task. In the first place one should be certain where the real incidence of the corporation tax rests. Under the view, argued fairly widely in recent years, that in some circumstances the main incidence of the corporation tax may be upon the customers, employees, or suppliers of the corporation, a tax credit to the shareholders would be substantially misplaced and without justification. This problem need not enter the picture at all, however, if the main purpose of the legislation is to encourage the flow of capital into the industrial system.

Furthermore, the attempt to confine the credit to those shareholders who bear the incidence of the tax can never be completely successful because the incidence of the tax is bound to vary with the level of profits. The preferred shareholder may escape the burden of the tax completely under normal profit conditions, only to find the tax cutting into his dividend when earnings fall off. He may later recover his fixed amount if he has cumulative rights. On the other hand, he may never recover the full amount to which he is entitled even upon the winding up of the company.

Not least of the problems met in attempting to have the credit follow the incidence of the tax is that of defining what for this purpose should constitute a preference. In many cases it will be found that all shareholders of a company have a preference of some sort in sequence. It would then be necessary to define the kind of preference which would not disqualify a shareholder, and this would be found to be no easy task. The results would be quite arbitrary. The legislation itself would be very complicated, and its administration would certainly be a source of great trouble both for the government and for the taxpayer.

Finally, if a government has decided to bear the cost of a tax credit to common shareholders it will find that the additional cost of allowing it to all shareholders will not be very large. Furthermore, to the extent that companies are induced to finance through preferred stock rather than bonds the additional corporate tax revenue resulting from the absence of an interest deduction more than offsets the cost of the 10 per cent tax credit on the dividend from these shares.

It is not surprising therefore that the Canadian Minister of Finance, after weighing the various considerations mentioned above, announced that he was prepared to recommend the tax credit for all classes of shareholders.

Change in Rate Structure

Closely related to the 10 per cent tax credit is the change in the corporate tax itself. From the commencement of the taxation of corporate profits in Canada the tax has always been at a flat rate. In recent years the rate has been 30 per cent. Under the reform program of last session the 30 per cent rate was reduced to 10 per cent on the first $10,000 of income of all corporations (except as qualified below) and

increased to 33 per cent on income in excess of $10,000.

This has meant a reduction in the tax bill for corporations with incomes under $76,666 but an increase where profits exceed this amount. Where, however, there is a reasonable distribution of earnings this increase in the tax paid by the corporation itself is more than offset by the reduction in tax to the shareholder under the 10 per cent tax credit provision. On balance then, where both provisions are applicable, their over-all effect, having regard to the corporation and shareholder taken together, is a reduction in tax. As a result of these two features the Minister of Finance was able to announce that double taxation had been completely removed on small businesses where profits were less than $10,000.

The 10 per cent rate on the first $10,000 of profit is not available to more than one company in a group of related companies. By definition, companies are related if they control or are controlled by another corporation or are controlled by the same individual. In the absence of this provision a profit of $2,300 a year (in tax saving) could be made by making two blades of corporate grass grow where one grew before. This provision also tends to confine the benefit of the low rate to the small businessman as distinct from small corporations as such, which small corporations may be controlled by a person with relatively ample funds for expansion at his disposal.

This abatement in the tax position of the small businessman may perhaps be a reflection of bleak prospects for a low future corporate tax rate in the face of high expenditure demands, as well as a recognition of the need under today's conditions for brightening the path of him who is ambitious to become an employer rather than an employee. Prewar levels of corporate tax obviously did not create a problem of the same proportions.

Increase in Loss Carry-over

Pre-1949 law in Canada permitted a one-year carry-back and a three-year carry-forward of losses. The recent legislation added two more years to the carry-forward, making it five. This gives a seven-year period for evening out the hills and valleys in the profit curve and should practically equalize the long-run effective tax rate of the feast-and-famine industries with that of the steady earners.

New Revenue Effects

The above mentioned changes in the corporate tax picture in Canada as a group are self-financing. It was estimated that the additional revenue from corporations with profits in excess of $76,666 as a result of the higher rate on profits in excess of $10,000 [1] would meet the combined cost of:

(a) the reduction to 10 per cent on the first $10,000 of the profit,

(b) the 10 per cent dividend credit to resident shareholders, and

(c) the addition of two years to the carry-forward of losses.

Amortization of Capital Costs

The program of policy changes just outlined coincides with the coming into force in Canada in 1949 of new income

[1] The increase in tax on corporations with profits in excess of $76,666 was not fully offset by the dividend credit because the credit is not available to nonresident shareholders and because no credit accrues on that portion of profits retained by corporations.

tax law. The old structure was completely overhauled and rewritten, the main substantive change in the process being an impressive surgical job on ministerial discretion. A further important move, also a product of general overhaul, although mainly of a technical nature, is more systematic provision for dealing with capital costs in computing profits. These modifications are popularly known as the new system of depreciation.

The old law contained specific provision for the depreciation and depletion allowances. The case for these allowances appears to have been related conceptually to the physical facts of wear and tear and exhaustion and could be justified only when the assets concerned were actually suffering wear and tear and exhaustion in the process of earning the income of the year being subject to tax. No allowance could properly be claimed on inactive portions of a plant or on discarded or obsolete machinery and equipment. On the other hand, no account was taken for tax purposes of the proceeds of assets disposed of regardless of the price realized or written-down value. Thus an asset, completely written off, could be disposed of at original cost without involving any tax consequences. This was obviously a somewhat hit-or-miss sort of system under which both government and taxpayer in turn might suffer unfairly or receive undue benefits. Low tax levels allow for a reasonable degree of tolerance in the law, but a nearer approach to perfection must be aimed at when the amounts at stake are as large as they inevitably are under today's rate structures.

The new law, without referring specifically to depreciation, depletion, or obsolescence, provides general authority for a deduction of "such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation." Parliamentary authority is therefore given for allowing all capital expenditure to be amortized, i.e., to be taken into account in computing profits. As a matter of policy, however, not all capital costs are eligible for a write-off. For example, the published regulation makes no provision for amortizing the cost of land. The main point is, however, that the new legislation enables a general policy in this field to be developed, whereas the old law specifically disallowed all capital costs and then made exceptions to the general rule for depreciation and depletion.

If, for purposes of computing profit, all capital outlays on ordinary depreciable assets are to be fully amortized (regardless of whether there is physical wear and tear, obsolescence, or decline in value), then it appears only reasonable that the system should not grant allowances in excess of the proper amount. There should be certainty in both directions. This conclusion clearly called for the taking into account of proceeds of disposal of any assets by the taxpayer. The final net cost of the assets should be determined, and this would, of course, represent the exact amount to which the taxpayer would be entitled in determining his write-off privileges.

In the light of the requirements under this new approach it was decided to

change over from the straight-line method of depreciation to the diminishing-balance principle with an appropriate increase in the rates (actually the rates have been approximately doubled in the main categories of assets). At the same time all depreciable assets are classified into a relatively small number of groups. In view of the fact that proceeds of disposal of any asset are to be taken into account, it is much less important that the rate of amortization be related exactly to the useful length of life of the asset. This fact made the grouping of assets a much simpler matter than otherwise would have been the case.

Under the new arrangement, which is essentially a pooling system, the cost of a new asset is added to the appropriate asset account. The proceeds from the disposal of an asset of a particular group are subtracted from the asset account of that group. If the disposal of an asset results in proceeds in excess of the balance of the asset account for that particular group, then the excess must be taken directly into profit and loss account. It is expected, however, that ordinarily the proceeds from the sale of an asset will merely operate to reduce future depreciation on other assets of the same class and will not have to be taken directly into profit and loss account.

It is believed that the above system of grouping of assets will greatly reduce the paper work involved in accounting for depreciation. It will be no longer necessary to preserve a history for individual assets. Acquisitions and disposals automatically increase or decrease the size of the asset account, and the published rate applies simply to the outstanding balance at the end of each year.

THE LOCAL FISCAL PROBLEM IN CONNECTICUT

K. M. WILLIAMSON *

THIS PAPER is concerned with certain aspects of the quest for new revenue on the part of Connecticut municipalities.[1] This problem is, of course, nationwide in scope, but it deserves separate study in each state. The justification for such studies in individual states lies in the variations among the states in economic and political factors, the structure of government, the degree of local financial strain, and over-all fiscal situation. The problem is important because in its solution in each state are involved many social values—adequate government services, efficiency of government operation, advantages of local autonomy, and vitality of democratic processes.

Factual Background of the Problem in Connecticut

The chief revenue source of the cities and towns of Connecticut, as of local governments elsewhere, is the general property tax, the rates of which are locally determined. In addition to the property tax, the Connecticut municipalities derive revenue from certain fees and miscellaneous charges and from payments by the State as shares of selected State taxes or for specific functions. In recent years, the local governments have obtained roughly four-fifths of their total income from the property tax, and four-fifths of property tax revenue has been derived from real estate.[2]

During the postwar period, the expenditures of Connecticut cities and towns have been rising. This rise has been due to increasing operating costs resulting from inflation [3] and to other factors in certain localities such as expanding services with growth of population, erection of new school buildings, and installation of sewers. The growth of expenditures has led to increase of property taxation, despite a substantial increase of State payments to the local governments.

The increase of property taxation in the postwar years is indicated by the movement of the total annual local tax levy of the State and of the tax rates of the individual municipalities. The total property tax levy grew from $91.5 millions in 1946 [4] to $115.2 millions in 1948,[5] or by roughly 25 per cent.

This increase was fairly general throughout the State. This is indicated by a comparison of the tax rates of the

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[1] Towns and cities.

[2] Statement to the Connecticut Tax Survey Committee from the Special Tax Study Committee of the Municipal Finance Officers' Association of Connecticut, November, 1948, p. 2.

[3] See, for a discussion of this influence of inflation in one of the cities, Hartford City Manager's Message to Council, 1948.

[4] Connecticut Public Document, No. 48, 1946, p. 9.

[5] Information supplied by the State Tax Department. Similar data are not available for 1949.

175 major municipalities[6] in 1946 and 1949. In 1949, 139 of these local units had higher rates than in 1946, 26 had lower, and 10 had the same rates.[7] It should be noted, however, that revaluations effective after 1946 were involved in 23 of the 139 cases of increase, in 23 of the 26 cases of decrease, and in 4 of the 10 cases of no change of rate.[8] In these cases the rate changes do not necessarily reflect proportionate alterations of the tax levy.

The extent of the increase of the rate, however, varied considerably among the municipalities. Of the 139 increases, 77 were under 5 mills in amount. Of the remaining 62 increases, 20 were as much as 5 but under 7 mills in amount, 26 were as much as 7 but under 10 mills, and 16 were 10 mills and over.

The rate increased in both small and large, rural and urban towns. The percentage of towns over 10,000 in population showing increases, however, was greater than that of towns in the smaller population size-groups. Whatever the increases, the question arises whether at existing levels of taxation, property is now more heavily taxed in the larger towns and cities than in the small and rural towns. It is difficult to answer this question definitively, since the rates are not comparable because of the difference in standards of valuation on which they are based. Despite this difficulty, a recent committee did make a comparison of towns by population size-groups and found that the average tax rate and the average per capita levy of a group increased progressively, by population size-groups, from the smaller to the larger towns. The committee, on this basis, suggested "that any excessive tax burden which the local property tax may represent is primarily associated with the assessment of property in the larger towns."[9]

Opposition to Increasing Property Taxes

Because of the increase and of the existing levels of the property tax, the municipalities of Connecticut, as in other states, are demanding new sources of revenue to supplement the property tax.[10] The grounds of the opposition to the Connecticut levels of property taxation are difficult to discover from the public discussion. From conversation with interested persons, however, the writer has gained the impression that

[6] Consisting of 169 towns and 6 separate cities not consolidated with the towns in which they are located. One of these cities, Stamford, is now consolidated with the town of Stamford, but, for comparability, this city is treated separately in 1949 as well as in 1946 in the comparison of tax rates.

[7] Based on Connecticut Public Document, No. 41, 1946, and on information supplied by the State Tax Department.

[8] Based on information from the State Tax Department. Under State law every town is required to revalue real estate for tax purposes during each period of 10 years. In accordance with this law all towns should have revalued such property during the 10-year period ending February 1, 1950. A large number of towns, however, would have failed to meet this deadline, and the 1949 legislature extended the revaluation period to February 1, 1953, thus deferring the deadline by 3 years. This experience may be in part due to the war and to postwar inflation, but it indicates, for this period, substantial inflexibility of valuation to changing conditions. This lag of revaluations coupled with the desire to keep tax rates down renders the local property tax less sensitive to inflation without relieving the upward pressure of rising prices upon local public expenditures.

[9] Report of the Connecticut State Tax Survey Committee, 1949, p. 164.

[10] Hartford City Manager's Message to Council, 1948; Statement to the Connecticut Tax Survey Committee from the Special Tax Study Committee of the Municipal Finance Officers' Association of Connecticut; and a Statement of Mayor Coleman of Hartford at a Public Hearing before the Connecticut Tax Survey Committee, December 14, 1948 (typewritten).

perhaps two considerations may be involved. One of these considerations is that the property tax in certain centers has reached its economic limit, and the other is that the tax is an inadequate and inequitable instrument for adjusting the burden of urban government cost between residents and nonresidents. These two considerations, as related to the Connecticut situation, will be examined.

The contention that the property tax has reached its economic limit is presumably based upon the fear that present or higher levels will cause loss of industry to other states or urban residential and industrial decentralization within the State.[11] As to the interstate aspects of the matter, considerable attention has been devoted to the alleged competitive disadvantages of the property tax in New England, especially with respect to the situation in Massachusetts.[12] So far as the writer knows, however, no adequate factual study has been made of the influence of the property tax upon the extent or the net balance of the movement of industrial plants into and out of Connecticut. A recent study was made of the various factors governing the location of 106 new manufacturing establishments in New England during the postwar period.[13] This study, being limited to inward movements, throws no light on outward migrations, but, since 32 of the firms covered were in Connecticut, the findings have some relevance to that State. As to the influence of the local tax factor upon new locations in the entire New England region, the author of the survey states: "It was frequently stated [by the executives interviewed] that, with the exception of situations where local officials expected the firm to bear too large a share of the local expenses, local assessments and taxes were not usually of a size sufficient to influence the location decision. The possibility of savings by differences in taxes imposed locally was small enough to be neglected." [14]

There is need of further research as to the effects of property taxation as a factor in deterring or attracting the location of firms in Connecticut. At the present stage of empirical evidence, however, there are at least some grounds for skepticism as to the extent to which the local tax factor may be adversely affecting Connecticut in gaining or retaining business establishments. Local property taxes, as well as many other types of state taxes, are often a relatively minor factor in costs. Moreover, the total state and local tax burdens in various states would appear to be more significant in location decisions than the local tax loads alone.

So much for the interstate aspects of the matter. Is the differential between the higher property tax rates of the cities and the lower rates of the towns adjacent to them causing residential and industrial decentralization of the urban centers? The fear of this possibility in the case of Hartford, for example, has

[11] The latter fear, rather than the first, has been mentioned to the writer in private conversation.

[12] See "Property versus Sales Tax," *Monthly Review of the Federal Reserve Bank of Boston*, June, 1948; "Massachusetts State Finances," *ibid.*, June, 1947; Seymour Harris, "New England's Decline in the American Economy," *Harvard Business Review*, Spring, 1947, pp. 364, 366, and 370; and C. D. Hyson and A. C. Neal, "New England's Economic Prospects," *ibid.*, March, 1948, p. 179.

[13] George H. Ellis, "Why New Manufacturing Establishments Located in New England: August 1945 to June 1948," *Monthly Review of the Federal Reserve Bank of Boston*, April, 1949.

[14] *Ibid.*, p. 11. As to the influence of state taxes upon location, the reader is referred to the article

been expressed to the writer. The existing Hartford rate of 37 mills is substantially higher than that of some of its satellite towns. Recent census data are not yet available, but indirect evidence seems to indicate that residential growth in recent years has been greater in the peripheral towns than in Hartford. If such is the case the Hartford area duplicates the alleged general pattern of metropolitan districts of the country. For it is claimed that the more rapid growth of the satellite towns than of the core cities is a nation-wide phenomenon.[15] Evidence is lacking, however, to prove that the differential rate of taxation is the cause of this population trend. Some considerations may be cited to the contrary. In the decade 1930-40, before the recent rise of tax rates, the satellite towns of the Hartford Metropolitan Area grew more rapidly than did the cities of Hartford and New Britain of that area.[16] Moreover, the trend of population away from the cities may be attributable to many forces, and it is doubtful if the tax factor alone is decisive.

What of the effects of urban property taxes upon industrial decentralization of the cities of Connecticut? Have the tax rates of the cities reached the level where the differential between urban and suburban rates is causing loss of industry by the cities? Here again, adequate evidence is lacking, and time and facilities have not been available to the writer to obtain the requisite data. A thorough investigation of the influence of the local tax factor upon urban and rural plant location in Connecticut is desirable. Perhaps the property tax has reached an economic limit in this State in the sense that it may be causing decentralization of industry from the cities, but the case for this position has not been proved. It is possible that the existing limit on property taxes in Connecticut may be as much political as economic.[17]

The present population trends, however, do limit the adequacy of the property tax as the chief means of financing city government. The increasing tendency of people to live outside the city and to work or trade in the city or use the recreational facilities of the city requires the central urban unit of a metropolitan area to provide services and improvements beyond the needs of its residents. The property tax, except for a possible limited amount of shifting, does not fall upon the nonresident beneficiaries of city expenditures. In this sense, therefore, under modern population developments, the property tax is not entirely equitable as the chief instrument for financing a core city of a metropolitan area. This is the second of two considerations mentioned above as involved in the opposition to increasing property taxation. In this aspect, perhaps, lies the more significant limit toward which property taxes are approaching. If the above observations are correct, the writer ventures to suggest that in the future more attention might be profitably given to the study of the impact of population trends upon local finance.

[15] W. L. C. Wheaton, "Our 'Exploding' Big Cities," *National Municipal Review*, March, 1949, pp. 130-32.

[16] Bureau of the Census, *Growth of Metropolitan Districts in the U. S., 1900-1940*, p. 37.

[17] For a similar view that the limit on property taxation, in the country in general, may be due as much to political as to economic causes, see Council of State Governments, *Report of the Committee on State-Local Relations*, p. 91.

Whatever the economic [18] or equity elements in the problem, there is little doubt that the political ceiling of the property tax is being approached.[19] It is likely, therefore, that in Connecticut as elsewhere the political solution will be a further increase by the State of financial aid to the municipalities in one form or another.

Present State Aid to Local Governments in Connecticut

The total payments by Connecticut to its local governments for 1947-48 [20] amounted to $25.6 million,[21] or roughly 14 per cent of the net expenditures of the State for that year.[22] This total was composed as follows: [23]

Categories	*Millions*
Shares of State-collected taxes and fees	$ 3.73
Education	11.74
Highways, docks, and buildings	6.26
Housing (aids to veterans' temporary housing)	1.42
Welfare: public assistance	2.38
Other	.08
Total	$25.61

It should be noted that while these aids go chiefly to towns and consolidated cities and towns, a small portion of the total is paid also to counties. Since the counties are in part financed by taxes assessed by them upon their constituent towns, the State payments to the counties serve to reduce these assessments upon the towns and thus indirectly aid the latter. Consequently, the total aids to local governments constitute State relief to the towns.

The legislative formulas governing the distribution of some of these aids—notably for education and roads—result in larger proportionate aids to the small and rural towns than to larger towns and cities. As evidence of this a study of a limited number of towns and cities by the writer showed that in a recent year some of the small towns derived substantial fractions of their total revenue from State payments, while two large cities studied obtained very minor percentages of their receipts from this source.[24] Another recent study shows that the smallest town of the State receives, in terms of percentage of property levy and of per capita amount, far greater aids for education and highways than Waterbury, which is one of the larger cities of the State.[25] Such proportionately unequal distribution of State aids between urban and rural centers has been criticized. Are such inequalities in aids justified by differences in wealth and taxable capacity and needs of the urban and rural, the large

[18] Consideration of the cyclical aspects of the local property tax is omitted above because of the nature of the article and the limitations of space.

[19] See, Council of State Governments, *op. cit.*, p. 91.

[20] The latest year for which official State data are available.

[21] Executive Budget of the State of Connecticut, submitted February 1, 1949, Supplement IV.

[22] The net expenditures of the State for 1947-48 were $177,070,723 (Report of the Comptroller for 1947-48, State Public Document, No. 1, p. 137).

[23] These data are not identical with those given by the Bureau of the Census in its *Compendium of State Government Finances in 1948*, p. 29. The difference is due to various definitions of state aid. See the Bureau monograph "State Aid to Local Governments," December, 1948. The excess of the above total over that of the Census Bureau is chiefly due to the treatment of highway expenditures. State expenditures within the towns for roads are included above, as if payments to the towns, since such expenditures aid the towns. Such direct expenditures by the State are excluded by the Census Bureau, since by its definitions such expenditures are not state aids.

[24] Space does not permit the inclusion of the data on which this statement is based.

[25] Committee of the Municipal Finance Officers' Association of Connecticut, *op. cit.*, p. 5.

and the small towns? It is not easy to measure the relative abilities of towns on which to base or to judge State aids. A serious difficulty is the present lack of uniformity among the towns in the assessment of property, which might otherwise serve as at least a rough index of taxable capacity.[26]

The present Connecticut system of allocation of aids also raises another important question. If, as has been said above, the property tax is not distributing equitably the cost of city government between urban and nonurban dwellers, does not the present system of aids, which allocates more to rural than to urban centers, aggravate rather than reduce this problem? The method of distribution of State payments would seem to deserve careful study and improvement to insure greater equity and efficiency in this use of the State's revenue resources.

Increased State Payments Versus Permissive Local Taxes

In Connecticut some consideration has been given to the question whether increased State aid to the local governments should take the form of State payments to the municipalities or of permission to impose new local taxes. The Committee of the Municipal Finance Officers' Association of the State recognized both methods but seemed to emphasize increased State payments as more adequate and practicable.[27] The movement for permissive local taxes in the State has so far apparently gained little headway,[28] but in view of the trend to that method in other states, the relative advantages of this policy as compared with that of extension of state payments for a state such as Connecticut will be briefly treated here.

Several purposes motivate the proponents of permissive taxes in other states.[29] Such taxes are urged as the means of implementing home rule and local financial autonomy, which are considered important for preserving democracy. Some local responsibility for taxation is doubtless desirable in local finance. It should not be lost sight of, however, that the local property tax, even when supplemented by receipts from the state, still remains as a substantial instrument of local finance. In this connection it is interesting to note that a British scholar, viewing experience in the United Kingdom, finds many virtues in the real estate tax as a means of exercising local financial autonomy.[30]

Another reason for resort to new local taxes is to avoid the tendency, already observed in Connecticut, of state legislatures to give cities disproportionately small shares of state aid payments. Permissive taxes in lieu of state payments are supported also because of alleged waste and inefficiency in expenditure of

[26] The Connecticut Public Expenditure Council asserts that, under a recent formula, the distribution of educational aids completely ignored considerations of needs and abilities and, on the basis of estimated real value of property, gave poor towns proportionately less than rich towns. See its "State Aid for Education," February 10, 1947.

[27] *Op. cit.*, p. 2.

[28] During 1949 chief consideration on the part of the Governor, legislative leaders, and others was given to increased State payments for education as the method of helping the local governments. A special session of the legislature is now (November, 1949) considering the demand for increased State aids for school buildings.

[29] For a good discussion of the relative merits of the two alternatives, see Tax Institute, Forum Pamphlet 4, "More State Aid or More Local Taxes," December, 1948.

[30] U. K. Hicks, *Public Finance* (London: Nisbet, 1947), pp. 269-73.

funds derived from state revenues. Probably an important objective in utilizing discretionary local taxes is to divert pressure away from the state capitols and, by decentralizing and distributing the decisions, to hold down public expenditures. Efficiency, limitation of excessive centralization, and prevention of waste are worthy objectives; but these ends should not be obtained by means which involve too high a cost in other values.

For this reason, the objections to the method of permissive taxes must be carefully weighed. So far as concerns this plan for Connecticut, a serious objection would be that the new taxing power would be ineffective for many municipalities because of lack of sufficient tax bases. Many of the small towns could not derive much revenue, for example, from a local income tax, sales tax, or amusement tax—to mention a few of the most likely new sources. Another difficulty with such local taxes in Connecticut would be that the towns and cities of the State are very close together. Even if such levies were feasible for the cities, the municipalities, being in proximity to one another, could compete by exemptions or different rates, with consequent disruption of trade [31] or the very decentralization which the cities now fear from differential property tax rates.

Moreover, general adoption of local income taxes might give rise, as in Pennsylvania, to serious jurisdictional conflicts between localities of employment and localities of residence.[32] In its original act of 1947, Pennsylvania provided that in case of such conflicts the government of residence shall have priority, the tax paid to the place of residence being deducted from that imposed by the place of employment. As the local income tax has spread to many local governments in Pennsylvania, the larger cities, despite their large commuting population, have lost income-tax revenue to the smaller communities because of this provision. This development under a local income tax thus prevents that levy from serving as an adequate means of sharing the costs of cities in metropolitan areas with the commuting population. Conceivably Connecticut, if it should adopt a permissive local income tax, might give priority in taxing income to the municipalities of employment, but this plan might not be acceptable in the Connecticut lower house in which the small and rural towns have predominant representation. It is perhaps indicative of the latter possibility that the Pennsylvania legislature of 1949 in amending its permissive tax act, while forbidding the taxation of income of nonresidents by school districts, continued to permit taxation of nonresidents by cities but failed to assign priority in deduction to the place of employment.[33]

Local taxes have other disadvantages. They are difficult and costly to administer in small local units.[34] They may cause heavy costs of compliance. Many of the local levies are regressive and may disproportionately increase the tax burden of the low-income groups.[35]

[31] See B. L. Johnson, "Denver Adopts Local Sales Tax," *National Tax Journal*, I (1948), 184-86.

[32] D. H. Kurtzman, "Local Income Tax Administration in Pennsylvania," in Tax Institute (symposium), *Income Tax Administration* (1948), pp. 312-15, 318.

[33] Richard C. Spaulding, "Pennsylvania Amends Permissive Local Tax Law," *National Tax Journal*, II (1949), 275.

[34] Tax Institute (symposium), *Income Tax Administration* (1948), pp. 312-13.

[35] *Ibid.*, pp. 332-49.

These disadvantages of local permissive taxes are impressive. Perhaps we can find a way to use some of these taxes; but—whatever their merits with respect to democracy, local autonomy, and popular fiscal discipline—their weaknesses tend to offset these virtues, which may be attainable in some other manner. For Connecticut, at any rate, it is the writer's judgment that if more financial assistance is to be given to the local governments it would be better policy to utilize further the system of State payments and to devote more thought to making that system workable.

A State Commission to Study State-Local Fiscal Relations

There is urgent need for the creation of a State commission to study the whole question of State-local fiscal relations in Connecticut in relation to the fiscal problem of the local governments. The State Tax Department has also recommended that such problems be studied.[36] A bill providing for a commission to study the problems was introduced in the 1949 regular session of the legislature, but it was not voted upon. It is unfortunate that the recent Connecticut State Tax Survey Committee regarded the matter of State-local fiscal relations as outside of its assignment. A comprehensive study and report of State-local fiscal relations would be well worth the effort and cost. Further action in this field should not, as in the past, be taken piecemeal. What is now needed is a consistent and comprehensive policy with respect to the State's financial relations to its local governments, shaped as a part of the over-all State fiscal policy. If such a policy is to have political implementation, it should be formulated by an official commission.

Space does not permit discussion of the agenda for study by such a commission, but some of the questions which such a body should consider may at least be enumerated. What is the aggregate amount of State aid appropriate for the Connecticut economy? What is the most equitable and effective method of distributing such aid? Should the existing system of sharing selected State taxes be continued? Should any local functions be centralized in the State? What are the advantages and practical possibilities of consolidation of local governments or of regional inter-town agreements for joint execution of functions or of larger metropolitan units of government? What are the economic effects of local property taxation? What would be the economic effects of additional State revenues required to extend further aid to relieve the local tax pressure upon property? Would such additional State taxes be more equitable than increased property taxes? How should the present local general property tax be reformed? Such are a few of the questions which deserve careful research as a basis of policy formation with respect to the local fiscal problem in Connecticut.

It will be obvious to the reader that throughout this paper the writer has asked more questions than he has answered. If, however, the questions are relevant, they may at least have the value of pointing to some of the directions in which the investigation of the local tax problem should proceed, not only in Connecticut but elsewhere.

[36] Digest of Connecticut Administrative Reports, 1947-48, Vol. 2, p. 49.

BOOK REVIEWS

Public Finance and National Income. By HAROLD SOMERS. Philadelphia: The Blakiston Company, 1949. Pp. xii + 132. $5.00.

It is extraordinarily difficult at the present time to write a textbook that meets the requirements of any large proportion of the teachers of public finance in American colleges. The instructor can hardly be equally expert in all phases of this complex subject. He therefore needs the help of a comprehensive and balanced treatment of a number of rather unrelated topics. In broadest terms the difficulty is to crowd into one volume both an adequate treatment of the institutional aspects of taxation and public spending and a respectable amount of income theory and fiscal policy. Most of the orthodox texts grossly neglect the latter; but recently this defect has, in a number of cases, been remedied. This undeniable improvement has been made, however, at the cost of shifting to the instructor much of the burden of dealing with the institutional and administrative aspects of taxation and public spending. The result has been that the instructor frequently resolves in favor of the traditional texts. Forced to make a choice, he is likely to prefer to reserve class time for analytical and theoretical problems. But this procedure destroys the integration of reading and class work, with adverse effects on student initiative. The dilemma is a serious one.

The present book is an impressive attempt to meet the above problem by integrating public finance with modern economic theory. To this end "purely administrative aspects" are justly subordinated. Great economy in writing is practiced, particularly in the discussion of taxes, in order to devote maximum space to the important questions of shifting and incidence, the economic effects of taxation and public spending, and the relation of public spending to national income. The general coverage of the book approximates that of a standard text. Its six parts comprise the role of government finance in the economy, expenditures, taxation, borrowing, state and local finance, and fiscal policy. The importance attached to the national income approach is at once made clear in a discussion of the public and private components of national income. Together with the parts on government borrowing and fiscal policy, it is the discussion of public spending that provides the author with his major opportunity to treat public finance "from a modern point of view." Unfortunately, because of the doubt in the author's mind concerning the audience he is trying to reach, a difficulty arises at once. The relation of government expenditures to consumer spending and business investment comprises the bulk (pp. 39-116) of the treatment of this crucial subject. Yet the reader is warned that both these chapters discuss the work of contemporary economists, and are on a "relatively technical level." They are in fact excellent and strongly recommended reading for the instructor. Because they partake of the character of a "history of dogma" (there are 61 footnote references in Chapter 4 and 155 in Chapter 5), proper use of a student's time suggests that he take the advice of the author, and proceed directly to the brief summary in Chapter 6. But this leaves a very large gap in a book of 527 pages.

A virtue of the book is the large amount of attention devoted to the economic effects of taxation. Here one finds the basic approach most clearly outlined. It takes the form of a crusade against the "fundamental fallacy running through 90 per cent at least of the tax shifting literature" (p. 162),

namely, that a tax which reduces savings necessarily discourages the formation of capital. "It cannot be stated too emphatically" (p. 184) that if the will to invest is present, business can borrow from the banks. It may be noted in passing that a most useful by-product of this zeal is the occasion it provides for the analysis of some of the key tax studies made in recent years. The main product is the focussing of attention on public finance aspects of the economics of underemployment. It is rather unfortunate, however, that the reiteration deemed necessary to establish the importance of this application of the underemployment case (the subject is brought up in various connections, and with growing impact; e.g., pp. 162, 184, 264, 288, 289, 309, 315, 361-70, 386, and 389), should tend to minimize the equally important condition of full employment. In the latter case reliance on bank credit to replace taxed savings must encourage price inflation; and if this is to be avoided, an increase in public investment implies a decrease in private investment regardless of willingness to invest. It would appear further that not enough is made of possible effects of the taxation of business savings on the marginal efficiency of investment, and that even if banks have adequate reserves, bank loans may not provide a perfect substitute for savings.

A growing realization in recent years of the importance of the economic effects of taxation emphasizes the need for better understanding of tax incidence. The author's statement (p. 160) that tax shifting theory is twenty-five years behind price theory may not command general agreement. Nevertheless, by dealing with a large number of instances and refinements with respect to each tax, he conveys, particularly to the student who is at home in diagrammatic analysis, a much better conception of shifting and incidence than is usually provided. Like all worthwhile commodities, this one must be paid for. The cost takes the form of frequent instances of summary treatment of matters really requiring more extended discussion. A not untypical example is the "highlights of the history of the federal income tax" (pp. 166-67). Here every sentence is really the topical sentence for a paragraph, and necessarily raises more questions than it answers. The result is ideal as a basis for class discussion, but it does not provide the kind of background needed by one who is new to the subject.

That the book fails to present sufficient descriptive material in the field of Federal taxes may be attributed partly to a tendency to regard such needed material as synonymous with the subordinated "purely administrative aspects," and partly to space-consuming over-emphasis on certain subjects that could have been treated much more briefly. Examples of the latter are: the views of Adams on the public debt; the effect of taxation of savings on investment, cited above; and the extended treatments of the multiplier and the accelerator. Yet many of the book's defects as a text for undergraduates arise out of its vigorous and original treatment, which the reviewer can only admire.

Kenyon E. Poole

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State and Local Revenues and Expenditures. By the [Virginia] Commission on State and Local Revenues and Expenditures. (Report to the Governor and the General Assembly, December 16, 1949.) Richmond: Commonwealth of Virginia, Division of Purchase and Printing, 1949. Pp. 200.

This report by the Virginia Commission on State and Local Revenues and Expenditures is a worthy addition to the long series of special-commission reports that has contributed greatly over the years to the raising of fiscal standards and practices in the United States. The twenty-one-member commission was appointed by the Governor in 1948 pursuant to a resolution of the

General Assembly directing a study of State and local revenues and State expenditures and grants-in-aid. For necessary technical work the commission contracted with the Bureau of Public Administration of the University of Virginia and engaged T. Coleman Andrews and Company to make a survey of the school-building situation in the State.

As a means of strengthening local revenue systems the commission stresses improvement in property tax assessments. It recommends a quadrennial general revaluation of real estate by one of three groups: (a) the technical staff of the State Department of Taxation, (b) a permanent local staff whose professional qualifications are approved by the Department of Taxation, or (c) private firms of valuation engineers to be approved by the Department of Taxation. When approved by the State Department of Taxation, the assessments would be taken as the true values of real estate for purposes of apportionment of State aid. The commission proposes that the State defray one-half of the cost of the first general revaluation. The majority of the commission recognizes the current practice of local underassessment of property and merely suggests that under the new system local officials formally determine a fraction of true values at which they wish to assess property and record this fraction of the 100 per cent valuation on local tax rolls. Suggestions are made for continuing assistance to local assessors by the State Department of Taxation, especially with regard to the appraisal of mineral property.

As a supplement to the property tax, the commission recommends that all counties and municipalities be allowed to levy (a) an admissions tax of not more than 10 per cent, (b) a motor vehicle license tax, (c) a hotel occupancy tax of not more than 5 per cent of the rental, (d) a business and occupation license tax on the objects taxed by the State at rates no higher than those imposed by the State, and (e) a utility consumers' tax at a standard rate of 5 per cent.

In a study of educational finance the commission found that in Virginia, as in other states, there are great variations in local ability to support schools, in local tax effort, and in local expenditures. The local unit with greatest fiscal ability has ten times as much wealth per pupil in average daily attendance as the poorest unit, more than eight times as much income per pupil as the lowest-income unit, and more than five times as many employed persons per pupil as the lowest unit on this basis. (Arlington County has greatest ability according to all three measures, but the local unit ranking lowest is different for each measure.) Local property tax rates for school purposes vary from $1.14 per $100 of estimated true value to $0.23. Total expenditures per pupil in average daily attendance range from $188 to $52. The commission admits that measurement of local ability, effort, and standards cannot be precise but contends that even the available data reveal gross inequalities in all three matters.

The State makes substantial grants to localities for school purposes. In 1948, these State grants amounted to $25 million, or 37 per cent of total school funds available from all sources. Virtually all of the State grants, however, are distributed without regard to local fiscal ability or effort to support education. (Most funds are distributed on a per pupil basis and at least do not require formal matching.) The commission recommends establishment of a larger equalization fund and proposes that future *increases* in State grants be distributed on an equalization basis. In view of the striking evidence of disparities in local fiscal ability and the endorsement of the principle of equalization, the actual recommendation is something of an anti-climax. The commission was doubtless impressed by the crudity of available measures of fiscal capacity and by the strength of vested interests in existing methods of distribution of State aid. Two members dissent from the majority position and recommend that greater emphasis be placed on the objective of equalization.

Among several recommendations on budgeting and financial organization, perhaps the most interesting is the suggestion that both the State and the localities prepare capital budgets covering at least six years. Most students of budgeting would doubtless regard this as a forward step and would concur in the judgment of the commission that capital budgets would contribute to improved planning and orderly execution.

The commission has proposed no striking innovations. But it has recommended many changes that most specialists will consider definitely desirable. The report is well written and well documented.

R. G.

Historical Statistics of the United States, 1789-1945. A Supplement to the *Statistical Abstract of the United States.* U.S. Department of Commerce, Bureau of the Census. Washington: Government Printing Office, 1949. Pp. viii+363. $2.50.

This historical supplement to the *Statistical Abstract of the United States* presents approximately 3,000 statistical time series covering various periods from 1789 to 1945. In a very few instances, figures are shown for earlier years. The volume was prepared by the Bureau of the Census in cooperation with the Social Science Research Council.

The material is presented in fourteen chapters and two appendixes. There are also a brief introduction and time-period and alphabetical indexes. The chapter headings are as follows: Wealth and Income; Population Characteristics and Migration; Vital Statistics, Health, and Nutrition; Labor Force, Wages, and Working Conditions; Agriculture; Land, Forestry, and Fisheries; Minerals and Power; Construction and Housing; Manufactures; Transportation; Price Indexes; Balance of Payments and Foreign Trade; Banking and Finance; Government. Each chapter includes descriptive notes and references on sources of data. A thirty-page appendix presents monthly and quarterly indicators of business conditions. A second appendix sets forth the basic premises underlying the preparation of the volume.

Students of public finance will find especially useful the data on wealth and income and the government chapter. The latter includes series on Federal Government employment, 1816-1945; total government employment, 1929-1945; Federal receipts and expenditures, classified by major items, 1789-1945; Federal debt, 1791-1945; Federal individual and corporation income tax returns, 1909-1945; state and local expenditures, classified by major items, 1890-1945; finances of major cities, 1902-1945.

Government Finance in a Stable and Growing Economy. The Annals of The American Academy of Political and Social Sciences, Volume 266, November, 1949. Pp. viii + 201 (also book reviews). $2.00.

This issue of *The Annals,* edited by Professor Alfred G. Buehler, contains twenty-six brief articles on various phases of government finance. Contributors include several well-known economists and businessmen, a labor leader, the Federal budget director, and a United States Senator. Most of the principal taxes receive some attention, and there are articles on budgeting and public debt. Primary emphasis is on broad policy questions rather than detailed analysis. Different points of view are represented. The material should be useful to informed laymen, college students, and specialists who wish a general survey of current thinking on government finance.

NTA NOTES

PITTSBURGH CONFERENCE PLANS

It is said that a well-known food processing company, whose name I will not mention because it is a competitor of one of our Pittsburgh friends, regularly and deliberately advertised its 21 different kinds of soups and then listed 22 kinds at the bottom of the ad. I was not indulging in a similar attempt to attract attention when I announced erroneous 1950 Conference dates in the December *Journal.* As all of you have been notified by postcard, the correct dates are September 11 to 14.

The headquarters hotel, the William Penn, is currently quoting the following rates:

Single bedrooms	\$ 4.50	to	\$ 7.50
Double bedrooms (for two)	6.75	to	10.00
Twin bedrooms (for two)	7.75	to	13.00
Suites (for one or two)	15.00	to	27.00

Hotel reservation cards will be sent you well in advance of the Conference.

Rates for other hotels within easy walking distance of the William Penn will be supplied on request.

RONALD B. WELCH
Secretary

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